Final Rule:

Revision of the Commission's Auditor Independence Requirements

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 240

[Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56;

File No. S7-13-00]

RIN 3235-AH91

Revision of the Commission's Auditor Independence Requirements

AGENCY: Securities and Exchange Commission

ACTION: Final rule

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

Effective Date: February 5, 2001.

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

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

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

I. Executive Summary

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II. Background

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

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

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

III. There Is a Need for Commission Rulemaking

A. The Independence Requirement Serves Important Public Policy Goals

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

The independence requirement serves two related, but distinct, public policy goals. One goal is to foster high quality audits by minimizing the possibility that any external factors will influence an auditor's judgments. The auditor must approach each audit with professional skepticism and must have the capacity and the willingness to decide issues in an unbiased and objective manner, even when the auditor's decisions may be against the interests of management of the audit client or against the interests of the auditor's own accounting firm.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) The Mix of Economic Incentives Has Changed

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

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

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

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

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

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

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

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

(ii) Changes in Incentives Are Likely to Affect Behavior

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

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

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

b. Certain Non-Audit Services Inherently Impair Independence

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

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

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

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

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

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

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

> Analysts are concerned that the acceptance of non-audit fees by auditors is likely to result in the independence of the audit being compromised. 94% of analysts stating an opinion believe that significant non-audit fees are likely to compromise audit independence. 76%

> of companies stating an opinion felt that auditor independence is likely to be compromised where significant non-audit fees are received from audit clients.[107]

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

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

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

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

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

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

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

> [T]he growing complexity of financial and economic relationships and the extent of non-audit services provided to audit clients by major accounting firms have significantly

> increased the perception and the potential for conflicts of interest and threatens the integrity of the independent audit function.[119]

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

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

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

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

4. <u>The Rules Are Appropriately Prophylactic</u>

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

a. <u>The Commission's Independence Rules Must Be Prophylactic</u>

Our approach to auditor independence traditionally has been, as it must be, prophylactic.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> It has been asserted there is as yet no `empirical evidence' demonstrating a loss of auditor independence in providing consultant and other non-audit services. In fact, we know otherwise.
>
> In prosecuting securities fraud cases against public companies and their auditors, we obtain access to internal corporate documents that are sealed from public view by confidentiality orders and are never made available to the Commission. Over the years, we have seen repeated instances where auditors are unable to maintain independence from their clients. Not infrequently, the lack of independence arises most directly from the fact that the auditing firm has substantial consulting relationships with the client - relationships that are extremely lucrative - much more lucrative than the auditing work.[153]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Whether the service is being performed principally for the audit committee
- The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process
- Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support
- Whether the service would be performed by audit personnel and, if so, whether it will

enhance their knowledge of the entity's business and operations

- Whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted) would be inconsistent with the auditor's role
- Whether the audit firm's personnel would be assuming a management role or creating a mutuality of interest with management
- Whether the auditors, in effect, would be auditing their own numbers
- Whether the project must be started and completed very quickly
- Whether the audit firm has unique expertise in the service
- The size of the fee(s) for the non-audit service(s)[175]

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

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

7. The Final Rules Will Not Diminish Audit Quality

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

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

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

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

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

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

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

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

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

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

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

b. Many Factors Affect Firms' Recruiting Efforts

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

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

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

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

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

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

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

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

c. The Rules Need Not Lead to Restructurings

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

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

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

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

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

We received many letters from small accounting firms expressing strong support for our proposal,[215] and the National Conference of CPA Practitioners, a national organization comprised of 1,200 member firms that represent 5,000 CPAs and service between 400,000 and

500,000 small and medium sized business clients, similarly wrote to express support for the proposal.[216] Indeed, some commenters pointed out that rather than harming the interests of the small practitioners, the rules could provide smaller firms with new business opportunities to provide non-audit services to companies that previously used their auditors to provide those services.[217]

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

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

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

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

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

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

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

10. The Final Rules Encourage International Efforts in This Area

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

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

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

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

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

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

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

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

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

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

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

IV. Discussion of Final Rules

A. The Preliminary Note

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

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

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

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

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

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

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

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

B. Qualifications of Accountants

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

C. The General Standard For Auditor Independence

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

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

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

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

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

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

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

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

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

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

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

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

D. Specific Applications of The Independence Standard

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

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

1. Financial Relationships

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

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

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

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

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

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

The balance we struck between these two sets of concerns was viewed favorably by many commenters.[268] We believe that fair, meaningful, and relevant independence rules concerning financial relationships should reflect a calibrated approach to determining what specific relationships realistically give rise to independence concerns. After considering the comments we received, we have drawn the lines essentially where we proposed -- "covered persons in the firm" and their immediate family members -- though we have modified slightly the definition of "covered persons" in the firm.[269] The final rule, like the proposed rule, would attribute all investments by a covered person's "immediate family members," that is, the covered person's spouse, spousal equivalent, and dependents, to the covered person.

a. Investments in Audit Clients

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. Other Financial Interests

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

(i) Loans/Debtor-Creditor Relationships

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

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

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

(ii) Savings and Checking Accounts

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

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

(iii) Broker-Dealer Accounts

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

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

(iv) Futures Commission Merchant Accounts

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

(v) Credit Cards

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

(vi) Insurance Products

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

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

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

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

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

(vii) Investment Companies

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

c. Exceptions

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

(i) Inheritance and Gift

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

(ii) New Audit Engagement

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

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

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

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

(iii) Employee Compensation and Benefit Plans

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

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

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

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

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

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

d. Audit Clients' Financial Relationships

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

(i) Investments by the Audit Client in the Auditor

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

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

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

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

(ii) Underwriting

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

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

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

2. Employment Relationships

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

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

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

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

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

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

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

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

a. Employment at Audit Client of Accountant

Rule 2-01(c)(2)(i) continues the principle set forth in current Rule 2-01(b) that to be independent, neither the accountant nor any member of his or her firm can be a director, officer, or employee of an audit client. Paragraph (2)(i) provides that an accountant is not independent if any current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client, or serves as a member of the board of directors or similar management or governing body of the audit client. In the most basic sense, the accountant cannot be employed by his or her audit client and be independent.

b. Employment at Audit Client of Certain Relatives of Accountant

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

3. Business Relationships

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

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

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

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

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

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

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

4. Non-Audit Services

a. General Rule

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

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

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

b. Particular Non-Audit Services that Impair Independence

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

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

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

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

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

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

(ii) Financial Information Systems Design and Implementation

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

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

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

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

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

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

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

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

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

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

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

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

(iii) Appraisal or Valuation Services and Fairness Opinions

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

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

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

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

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

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

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

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

(iv) Actuarial Services

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

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

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

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

(v) Internal Audit Services

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

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

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

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

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

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

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

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

In addition, the final rule does not restrict internal audit services regarding operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

This is because our focus is on services that affect the integrity of financial statements and reported financial information.[397]

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

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

(vi) Management Functions

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

(vii) Human Resources

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

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

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

(viii) Broker-Dealer Services

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

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

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

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

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

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

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

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

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

(ix) Legal Services

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

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

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

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

(x) Expert Services

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

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

c. Alternative Approaches to Scope of Services Restrictions

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

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

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

5. Contingent Fees

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

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

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

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

E. Quality Control Provisions

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

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

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

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

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

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

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

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

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

1. Written Independence Policies and Procedures

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

2. Automated Systems

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

3. Timely Information

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

4. Training

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

5. Internal Inspection and Testing

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

6. Notice of Names of Senior Management Responsible for Independence

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

7. Prompt Reporting of Employment Negotiations

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

8. Disciplinary Mechanism

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

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

F. Transition and Grandfathering

1. Transition

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

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

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

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

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

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

b. <u>Other Financial Interests and Employment Relationships</u>

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

c. <u>Quality Control Systems</u>

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

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

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

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

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

2. Grandfathering

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

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

3. Settling Financial Arrangements with Former Professionals

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

G. Proxy Disclosure Requirement

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

1. Disclosure of Fees

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

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

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

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

We are also requiring disclosure of fees billed for non-audit services, other than information technology services, rendered by the principal accountant in the last fiscal year. While we proposed to require disclosure of fees for each service as discussed above, we have determined to require only disclosure of aggregate fees billed for non-audit services, excluding information technology services. As noted above, commenters generally favored more simple disclosure, believing it is more useful to investors. In requiring disclosure of aggregate fees, we are adopting a disclosure requirement that is similar to the disclosure that the United Kingdom has required since 1989. As discussed in the Proposing Release, since 1989, the British government has required companies to disclose their annual audit fee and fees paid to their auditor for non-audit services.[470] "The [British] government believes that the publication of the existence of, and extent of, non-audit consultancy services provided to audit clients will enable shareholders, investors, and other parties to judge for themselves whether auditor independence is likely to be jeopardized."[471]

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

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

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

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

2. Audit Committee Disclosure

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

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

3. Leased Employees

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

4. Proxy Statement

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

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

H. Definitions

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

1. "Accountant"

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

2. "Accounting Firm"

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

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

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

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

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

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

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

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

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

3. "Affiliate of the Audit Client"

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

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

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

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

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

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

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

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

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

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

4. "Audit and Professional Engagement Period"

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

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

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

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

5. "Audit Client"

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

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

6. "Audit Engagement Team"

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

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

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

7. "Chain of Command"

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

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

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

8. "Close Family Members"

We are adopting, as proposed, Rule 2-01(f)(9) that defines "close family members." Close family members is defined to mean a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling. These terms should be understood in terms of contemporary family relationships. Accordingly, "spouse" means a husband or wife, whether by marriage or under common law; "spousal equivalent" means a cohabitant occupying a relationship generally equivalent to that of a spouse; "parent" means any biological, adoptive, or step-parent; "dependent" means any person who received more than half of his or her support for the most recent calendar year from the relevant covered person; "child" means any person recognized by law as a child or step-child; and "sibling" means any person who has the same mother or father.

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

9. "Covered Persons in the Firm"

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

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

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

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

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

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

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

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

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

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

10. "Immediate Family Members"

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

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

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

11. "Investment Company Complex"

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

We solicited comment on the definition proposed, and, in particular, on whether an alternative definition, focusing on the fund's principal underwriter and administrator would be more appropriate. Some commenters expressed concern about the scope of the investment company complex definition, particularly that it included entities that have no direct relationship to investment company operations.[518] These commenters' concern was that all subsidiaries of an adviser's parent company would also be included in the investment company complex.

Therefore, an accounting firm could not provide certain non-audit services to, or invest in, subsidiaries of the parent of the adviser, even if those subsidiaries operated businesses unrelated to the investment company business. Under the proposed definition, for example, if a parent company owned an adviser and a manufacturing company, the accountant that audited the adviser (or a fund advised by the adviser) could not invest in the manufacturing company, even though its operations would not be affected by the audit of the adviser (or the fund).

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

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

12. "Office"

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

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

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

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

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

I. **Codification**

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

V. Cost-Benefit Analysis

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

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

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

1. Benefits

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

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

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

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

2. Costs

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

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

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

In addition to requirements imposed by GAAS, public accounting firms that are SECPS members must comply with independence quality control membership requirements. Further, SECPS guidelines indicate that its members are required to assist their foreign associated firms to conform to "U.S. independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent."[534] Among other things, member firms with at least 7,500 professionals must implement an electronic tracking system by no later than December 31, 2000.[535] The final rule supplements the GAAS requirement for firms with more than 500 SEC registrants as audit clients by identifying procedures that should be part of their quality control systems. Because an accounting firm with 500 SEC registrants will likely also meet the SECPS' 7,500 professionals requirement, the rule is unlikely to impose a requirement for quality controls that does not already exist under GAAS and SECPS membership requirements.

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

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

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

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

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

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

Under the final rule, accounting firms may provide all internal audit services to audit clients with assets of $200 million or less, provided certain conditions are met. In addition, accounting firms may provide up to forty percent of the internal audit services of issuers with assets in excess of $200 million, provided the same conditions are met.[540]\\NTSERVEUR\data\Nouveau\Travaux CCBE\Lawyers and Market Place\US Securities and Exchange Commission rules.htm - P1183_477235 These conditions are intended to create circumstances in which the auditor can continue to exercise objective and impartial judgment, and the audit retains its value as a "second opinion."

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

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

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

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

Current and past bank regulators expressed concern about the effect of our internal audit proposal on smaller banks serving smaller communities.[544] The $200 million threshold is designed to limit the impact of the rule to larger, national banks. The Compustat Database included 682 bank holding companies. Of these, 591 (86.7%) have assets of $200 million or more and 91 (13.3%) have assets of less than $200 million. Big Five accounting firms audit 382

(64.6%) of the large bank holding companies. The next three largest (second tier) firms audit 31 (5.2%) of the large bank holding companies. Compustat specifically identified 116 (19.6%) as audited by other accounting firms. The data source did not identify an auditor for the remaining 62 (10.5%) companies.[545] The $200 million exemption permits the 91 smaller bank holding companies, likely to serve smaller communities[546], to obtain from their auditors internal audit services. Accordingly, as adopted, the rule should not impose a substantial burden on these institutions and the communities they serve. Further, the Compustat criteria for inclusion in the database may understate the population of smaller bank holding companies.

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

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

1. Benefits

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

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

a. Investors

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

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

Some commenters suggested that there is no empirical evidence that shows that the provision of non-audit services damages investors' confidence in the independence of auditors or the accuracy of financial statements.[554] Commenters suggested that there is, therefore, no basis for our assertion that the rule will benefit investors.[555] One such commenter suggested that the rule might, in fact, decrease investor confidence. This commenter argued that investors believe that the rule may decrease the quality of audits because auditors will know less about the companies they audit.[556] However, other commenters suggested that providing consulting services does not improve the quality of audits.[557]\\NTSERVEUR\data\Nouveau\Travaux CCBE\Lawyers and Market Place\US Securities and Exchange Commission rules.htm - P1217_492998 There is also academic and survey evidence that users of financial statements believe that the provision of non-audit services may impair the auditor's independence.[558] A public opinion poll conducted by Public Opinion Strategies found that approximately eighty percent of investors favor a rule that imposes such restrictions.[559] Another survey, conducted by AIMR, reported that over sixty-two percent of responding analysts believe that providing outsourcing services would likely compromise or impair auditor judgment.[560] Brand Finance, in a survey of U.K. analysts, found that ninety-four percent of respondents believed that the current level of non-audit service fees was likely to compromise auditor independence.[561]

b. Issuers

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

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

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

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

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

c. Public Accounting Firms

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Costs

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

a. Issuers

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

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

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

b. Public Accounting Firms

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

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

c. Shared Costs

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. Costs and Benefits of the Disclosure Requirements

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

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

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

1. Benefits

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

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

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

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

2. Costs

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

Disclosure of audit and non-audit fees will impose a reporting burden on all issuers subject to the proxy disclosure rules. For the purpose of the Paperwork Reduction Act, we estimated the aggregate reporting cost of $272,620 to complete the appropriate paperwork.[621] Commenters suggested that this estimate is unreasonably low.[622] Some commenters suggested that registrants would spend more time making the required disclosures. We do not agree; the disclosures can be made using information that registrants will have on hand. We also note that the scope of the required disclosure has been significantly reduced from the proposal, limiting it to only aggregate audit, IT, and other non-audit fees. For the purpose of providing an aggregate cost estimate, we consider a range of $272,620 and $1.09 million, but use only the top of this range for the total. The rule will not impose significant burdens related to storing, analyzing and compiling data, or to training employees. Moreover, even if registrants spend more time in making the required disclosure, the marginal increase in cost will not be significant relative to the overall costs discussed in this section. Even assuming the burden is four times as great to make the disclosure, the annual cost of complying with the disclosure portion of the rule would be $1.09 million.

D. Estimated Aggregate Costs and Benefits

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

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

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

VI. Final Regulatory Flexibility Analysis

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

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

A. Reasons for and Objectives of the Rule Amendments

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

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

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

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

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

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

B. Significant Issues Raised by Public Comment

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

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

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

C. Small Entities Subject to the Rule

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

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

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

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

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

E. Agency Action to Minimize Effect on Small Entities

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

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

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

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

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

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

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

VII. Paperwork Reduction Act

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IX. Codification Update

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

1. By removing section 602.01.

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

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

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

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

6. By removing section 602.02.b.iv.

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

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

9. By removing section 602.02.c.ii.

10. By removing section 602.02.c.iii.

11. By removing section 602.02.d.

12. By removing section 602.02.e.ii.

13. By removing section 602.02.e.iii.

14. By removing section 602.02.f.

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

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

17. By removing section 602.02.h.

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

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

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

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

X. Statutory Bases and Text of Amendments

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

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

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

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL

STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

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

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

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

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

§ 210.2-01 Qualifications of accountants.

Preliminary Note to § 210.2-01

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

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

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

(a) * * *

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or

substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

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

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

(A) Any service involving:

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

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

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

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

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

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

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

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

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

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

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

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

(ii) Financial information systems design and implementation.

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

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

(1) The audit client's management has acknowledged in writing to the accounting firm and the

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

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

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

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

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

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

(iii) Appraisal or valuation services or fairness opinions.

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

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

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

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

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

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

(iv) Actuarial services.

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

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

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

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

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

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

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

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

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

(v) Internal audit services. Either of:

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

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

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

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

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

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

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

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

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

(vii) Human resources.

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

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

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

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

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

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

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

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

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

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

(2) The covered person's lack of independence was corrected as promptly as possible under the

relevant circumstances after the covered person or accounting firm became aware of it; and

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

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

(i) Written independence policies and procedures;

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

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

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

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

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

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

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

(e) Transition and grandfathering.

(1) Transition.

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

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

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

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

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

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

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

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

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

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

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

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

(4) Affiliate of the audit client means:

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

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

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

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

(5) Audit and professional engagement period includes both:

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

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

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

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

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

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

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

(8) Chain of command means all persons who:

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

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

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

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

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

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

(i) The "audit engagement team";

(ii) The "chain of command";

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

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

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

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

(14) Investment company complex.

(i) "Investment company complex" includes:

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

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

(1) Is an investment adviser or sponsor; or

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

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

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

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

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

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

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

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

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

* * * * *

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

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

* * * * *

Item 9. Independent public accountants. * * *

* * * * *

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

249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.

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

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

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

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

By the Commission.

Jonathan G. Katz
Secretary

November 21, 2000

Erreur! Nom du fichier non spécifié.

Erreur! Nom du fichier non spécifié.

Footnotes

[1] 17 CFR 210.2-01.

[2] 17 CFR 240.14a-101.

[3] 15 U.S.C. § 78a et seq.

[4] The amendments were proposed in Securities Act Release No. 7870 (June 30, 2000) (the "Proposing Release") [65 FR 43148].

[5] This release uses the terms "independent auditor," "auditor," "independent public accountant," "accountant," and "independent accountant" interchangeably to refer to any independent certified or independent public accountant who performs an audit of or reviews a public company's financial statements or whose report or opinion is filed with the Commission in accordance with the federal securities laws or the Commission's regulations.

[6] In addition to soliciting comments in the Proposing Release, we held four days of public hearings (July 26, Sept. 13, Sept. 20, and Sept. 21). The public comments we received can be reviewed in our Public Reference Room at 450 Fifth Street, N.W., Washington, D.C., 20549, in File No. S7-13-00. Public comments submitted by electronic mail are on our website, www.sec.gov. The written testimony and transcripts from each of our public hearings (July 26, Sept. 13, Sept. 20, and Sept. 21) are available on our website. For purposes of this release, date references following the names of participants at our public hearings indicate the hearing date for which the participant submitted written testimony and/or appeared as a witness.

[7] The profession's principles of professional conduct state, "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." American Institute of Certified Public Accountants ("AICPA") Professional Standards: Code of Professional Conduct ("AICPA Code of Professional Conduct"), ET § 53.

[8] Public companies and other public issuers and entities registered with us must have their annual financial statements audited by independent public accountants. See, e.g., Items 25 and 26 of Schedule A to the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77aa(25) and (26), that expressly require that financial statements be audited by independent public or certified accountants. See also infra note 34.

[9] See, e.g., Testimony of John Whitehead, retired Chairman, Goldman Sachs & Co. (Sept. 13, 2000) ("Financial statements are at the very heart of our capital markets. They're the basis for analyzing investments. Investors have every right to be able to depend absolutely on the integrity of the financial statements that are available to them, and if that integrity in any way falls under suspicion, then the capital markets will surely suffer if investors feel they cannot rely absolutely on the integrity of those financial statements.").

[10] As stated by Baxter Rice, President of the California Board of Accountancy, "[I]n this ever-revolving economy and business environment, it's important that we go back and take a look at these regulations and see whether they are really applicable, and whether or not what we do is going to in any way interfere with or is going to enhance auditor independence, including the public perception of auditor independence." Testimony of Baxter Rice (Sept. 13, 2000).

[11] Financial Reporting Release ("FRR") No. 10 (Feb. 25, 1983).

[12] In 1999, an estimated 48.2%, or 49.2 million, U.S. households owned equities either in mutual funds or individually, up from 19% in 1983. Investment Company Institute and Securities

Industry Association, "Bull Market, Other Developments Fuel Growth in Equity Ownership" (available at www.sia.com/html/pr834.html.).

[13] See, e.g., Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000) ("Our nation's current prosperity and future financial security are tied up as never before in our financial markets. For that reason, whether they know it or not, Americans are enormously dependent on independent auditors, both to . . . ensure the reliability of the information they use to make individual investment decisions and to ensure the efficiency of the marketplace in assigning value to stocks."); Testimony of Ralph Whitworth, Managing Member, Relational Investors LLC (Sept. 13, 2000) ("[A]uditor independence goes to the very essence of our capital markets, and it's linked inextricably to the efficiencies of our capitalist system.").

[14] See discussion in Proposing Release, Section II.B.

[15] See, e.g., Written Testimony of Dennis Paul Spackman, Chairman, National Association of State Boards of Accountancy (Sept. 13, 2000) (The four principles "set a sensible baseline that is simply stated, easy to understand, useable, and square on the mark. They also serve as an exceptional foundation to the other elements of the proposed revision. . . . [T]hey can serve as a bright beacon giving much needed guidance to members of the profession . . . ."); Written Testimony of Robert L. Ryan, Chief Financial Officer, Medtronic, Inc. (Sept. 20, 2000); Written Testimony of John C. Bogle, Member, Independence Standards Board (July 26, 2000).

[16] See, e.g., Letter of Arthur Andersen LLP (Sept. 25, 2000) ("Arthur Andersen Letter"); Written Testimony of the New York Society of Certified Public Accountants (Sept. 13, 2000).

[17] See, e.g., Letter of Ernst & Young LLP (Sept. 25, 2000) ("Ernst & Young Letter"); Written Testimony of James J. Schiro, Chief Executive Officer PricewaterhouseCoopers (Sept. 20, 2000); Written Testimony of the New York State Society of Certified Public Accountants (Sept. 13, 2000); Written Testimony of James E. Copeland, Chief Executive Officer, Deloitte & Touche LLP (Sept. 20, 2000); Arthur Andersen Letter.

[18] Some commenters, for example, believed that the amendments went too far. See, e.g., Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) (supporting proposed rule changes in this area but stating that no partner in an accounting firm should have a financial interest in any of the firm's audit clients); Written Testimony of Ray J. Groves, former Chairman and CEO, Ernst & Young (July 26, 2000) (agreeing with proposals but stating preference to retain current proscription of direct investment in an audit client by all partners, principals, and shareholders of an accounting firm); Testimony of Paul B.W. Miller, Professor, University of Colorado at Colorado Springs (July 26, 2000) ("I want to direct my attention ... to the ownership [provisions], and my language is plain. It simply says don't do it"); Written Testimony of Ronald Nielsen and Kathleen Chapman, Iowa Accountancy Examining Board (Sept. 20, 2000). While supporting the goals of the modernization, others provided suggestions to address their concerns about possible unintended consequences. See, e.g., Ernst & Young Letter; Letter of PricewaterhouseCoopers LLP (Sept. 25, 2000) ("PricewaterhouseCoopers Letter").

[19] See infra Section III.C; see also Proposing Release, Section II.C.

[20] The Panel on Audit Effectiveness: Report and Recommendations (the "O'Malley Panel Report"), at ¶ 5.6 (Aug. 31, 2000). The Chairman of the Public Oversight Board ("POB") similarly warned about the "uncontrolled expansion" of management advisory services to audit clients. Letter from John J. McCloy, Chairman, POB (former Chairman of the Board of Chase Manhattan Bank and former President of The World Bank), to Walter E. Hanson, Chairman, Executive Committee, SEC Practice Section ("SECPS") (Mar. 9, 1979).

[21] See, e.g., Testimony of Robert E. Denham, Member, Independence Standards Board ("ISB") (July 26, 2000) ("I think [the proposals] represent a very thoughtful, rational, coherent set of proposals."); Letter of Michael McDaniel (Aug. 14, 2000) (supporting SEC proposal and disagreeing with a Form Letter from the AICPA to its members ("AICPA Form Letter") urging them to write to the SEC to oppose the scope of services proposal); Letter of Randie Burrell, CPA (Aug. 14, 2000) (same); Letter of Leland D. O'Neal, CPA (Aug. 15, 2000) (same); Letter of David A. Storhaug, CPA (Aug. 21, 2000) (same); Letter of Arthur Gross (Sept. 10, 2000); Letter of Kristian Holvoet (Sept. 8, 2000); Letter of Bettina B. Menzel (Sept. 9, 2000); Letter of Robert Hanseman (Sept. 10, 2000); Written Testimony of Thomas S. Goodkind, CPA (Sept. 13, 2000); Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000); Written Testimony of Bill Patterson, Director, Office of Investments, AFL-CIO (Sept. 20, 2000); Written Testimony of Frank Torres, Consumers Union (Sept. 20, 2000); Testimony of Nimish Patel, Attorney, Pollet & Richardson (July 26, 2000). See also Senator George J. Mitchell (Ret.), "How to Keep Investor Confidence," Editorial, Boston Globe, pg. A15 (Oct. 28, 2000) ("The commission's proposal is well-reasoned and appropriate. . . . [T]he commission should adopt this rule to protect investor confidence and strengthen the most vibrant financial market system in the world.").

[22] See, e.g., Written Testimony of Kayla J. Gillan, General Counsel, California Public Employees' Retirement System ("CalPERS"), which is the largest public retirement system in the United States with over 1.2 million participants (Sept. 13, 2000) ("The SEC should consider simplifying its Proposal and drawing a bright-line test: no non-audit services to an audit client."); Written Testimony of John H. Biggs, Chairman and CEO of TIAA-CREF, which has 2.2 million participants (July 26, 2000) ("[I]ndependent public audit firms should not be the auditors of any company for which they simultaneously provide other services. It's that simple,"); Written Testimony of Alan P. Cleveland, the New Hampshire Retirement System, with 52,000 members (Sept. 13, 2000) ("We regard the concurrent performance by the company's external auditor of non-auditor services at the direction and under the control of management to be inherently corrosive and fundamentally incompatible with that duty of independence and fidelity owed by the auditor to the investing public"); Testimony of Jack Ciesielski, accounting analyst (July 26, 2000) ("I think the single best way to improve auditor independence and the appearance of auditor independence is to call for an exclusionary ban on non-audit services to audit clients."); Letter of Carson L. Eddy, CPA, (Aug. 22, 2000) ("It is my opinion that the general public would be better served if Certified Public Accountants providing the attest function for a client were unable to do any other consulting work for that client, with the exception for the ability to prepare tax returns."); Letter of William V. Allen, Jr., CPA (Aug. 22, 2000); Letter of Terry Guckes (Sept. 9, 2000); Letter of Art Koolwine (Sept. 8, 2000); Letter of Elliot M. Simon (Sept. 9, 2000); Letter of Melvin Schupack (Sept. 9, 2000); Letter of William Odendahl (Sept. 5, 2000).

[23] See, e.g., Letter of the AICPA (Sept. 25, 2000) ("AICPA Letter"); Letter of KPMG (Sept. 25,

2000) ("KPMG Letter"); Letters of Robert Roy Ward, Chairman and Chief Executive Officer, Horne CPA Group (Sept. 20, 2000), Douglas R. Ream, CPA (undated), Jack W. Palmer (Sept. 9, 2000), Sherry Wilson, CPA (Aug. 28, 2000), and Nathaniel Boyle, CPA (Aug. 16, 2000) (each reiterating concerns expressed in the AICPA's Form Letter).

[24] See, e.g., Ernst & Young Letter; PricewaterhouseCoopers Letter.

[25] Commenters generally agreed that disclosure would be useful to investors. See, e.g., Written Testimony of James W. Barge, Vice President and Controller, Time Warner (Sept. 20, 2000); Letter of The Institute of Internal Auditors (Sept. 5, 2000); Written Testimony of Dennis Paul Spackman, Chairman of the National Association of State Boards of Accountancy (Sept. 13, 2000); Letter of Marsha Payne, President, Association of College & University Auditors (Sept. 25, 2000); Letter of Keith Johnson, Chief Legal Counsel, State of Wisconsin Board (Sept. 20, 2000); Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investments, TIAA-CREF (Sept. 21, 2000).

[26] See, e.g., Written Testimony of Clarence E. Lockett, Vice President and Corporate Controller, Johnson & Johnson (Sept. 20, 2000); Written Testimony of Philip A. Laskawy, Chairman, Ernst & Young LLP (Sept. 20, 2000).

[27] See written testimony and transcripts from each of our hearings.

[28] A Proposal by the Securities and Exchange Commission to Modernize Its Rules That Govern the Independence of Accountants that Audit Public Companies, Before the Subcomm. on Securities of the Senate Comm. On Banking, Housing, and Urban Affairs, 95th Cong. 2d Sess. (Sept. 28, 2000).

[29] See, e.g., Letter of KPMG; Written Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 13, 2000) ("There is no reason...for a rush to judgment on these critical issues. We have the time to get it right, and the public is entitled to nothing less."); Written Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 13, 2000); Letters of Richard W. Hammel, CPA (Sept. 25, 2000), Roland H. Flyge II, CPA (Sept. 23, 2000), and Daniel P. Naragon, CPA (Sept. 25, 2000) (each reiterating concerns expressed in the AICPA Form Letter).

[30] See Written Testimony of Bevis Longstreth, former SEC Commissioner and member of the Panel on Audit Effectiveness (Sept. 13, 2000) ("The SEC acting upon the need for greater independence, a need long recognized by virtually every group assigned the task of considering the issue (and there have been many), has proposed a rule to meet this need."); Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000); Written Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("This issue is not new. The issue has been debated within the profession and by others for over 20 years. The only thing that has changed, in my opinion, is that the risks to the system have increased."); Written Testimony of Dennis Paul Spackman, Chairman of the National Association of State Boards of Accountancy (Sept. 13, 2000) ("[A]ction is needed. Indeed, I believe it is long over due. While further study may enhance the finer points of the issues, it would do nothing to resolve the larger concerns. They have been deliberated far too long."); Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000) ("I firmly believe the SEC is taking a correct position in this long debated area of concern to the profession.").

[31] Congress itself considered the issue of scope of services in the 1970s. See Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (Comm. Print Nov. 1977).

[32] In the late 1980s, for example, several of the large public accounting firms filed a petition with us seeking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. See Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kullberg, Arthur Andersen & Co. (Feb. 14, 1989) (denying the petition).

[33] See Richard C. Breeden, Roderick M. Hills, David S. Ruder and Harold M. Williams (former Chairmen of the SEC), Editorial, "Accounting for Conflicts," Wash. Post, at A31 (July 21, 2000) ("This initiative is timely and necessary. . . . [T]he time has come to chart a surer path to preserving the all-important principle of auditor independence from commercial client relationships."); James J. Schiro, Chief Executive Officer, PricewaterhouseCoopers LLP, "Auditor Independence: It's Time to Change the Rules," Wall St. J. (Oct. 10, 2000) ("New rules are needed now. Working together, we can devise rules that will protect the public interest today and for decades to come. The need for change is upon us. Further delay will only prolong confusion at a time when greater clarity is needed.") (emphasis in original); Written Testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000) ("[A] more compelling question is, why wait? . . . Speaking for consumers across the country, we urge the Commission to move forward expeditiously with this important rule proposal."); Testimony of Professor John C. Coffee, Columbia University (July 26, 2000) ("Right now you have the appropriate moment because the vast majority of firms aren't purchasing dual services. If you wait ten years, that will change, and [it's] much harder to change an existing reality rather than an approaching change. So I think this is the time for action . . . ."); Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("[T]he Commission's consideration of this issue at this time is both warranted and necessary. The status quo is not an acceptable answer."); Written Testimony of Professor Curtis C. Verschoor, DePaul University (July 26, 2000) (stating that the question is "[n]ot why so fast, but what took so long?"); Letter of John S. Coppel, CPA, CFO, Electric Power Equipment Company (Aug. 16, 2000) ("I view this rule as a long overdue, greatly needed response to the practices now taking place within the profession.").

[34] For example, Items 25 and 26 of Schedule A to the Securities Act, 15 U.S.C. §§ 77aa(25) and (26), and Section 17(e) of the Exchange Act, 15 U.S.C. § 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. §§ 78l and 78m, Sections 5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935 ("PUHCA"), 15 U.S.C. §§ 79e(b), 79j, and 79n, Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 ("ICA"), 15 U.S.C. §§ 80a-8 and 80a-29, and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Under this authority, the Commission has required that certain financial statements be audited by independent accountants. See, e.g., Article 3 of Regulation S-X, 17 CFR 210.3-01 et seq. In addition, public companies must have their quarterly reports reviewed by independent accountants. Article 10 of Regulation S-X, 17 CFR 210.10-01(d) and Item 310(b) of Regulation

S-B, 17 CFR 228.310(b). The federal securities laws also grant the Commission the authority to define the term "independent." Section 19(a) of the Securities Act, 15 U.S.C. § 77s(a), Section 3(b) of the Exchange Act, 15 U.S.C. § 78c(b), Section 20(a) of PUHCA, 15 U.S.C. § 79t(a), and Section 38(a) of the ICA, 15 U.S.C. § 80a-37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act. Section 17 of the Exchange Act, 15 U.S.C. §78q, and Section 31 of the Investment Company Act, 15 U.S.C. § 80a-30, grant the Commission authority to prescribe accounting principles to be used in the preparation of financial statements required.

[35] Steven M. H. Wallman, "The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change," Accounting Horizons, at 81 (Sept. 1995).

[36] See generally Codification of Financial Reporting Policies (the "Codification") § 601.01 ("An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest."). Use of the term "Codification" means the Codification that existed prior to the Commission's adoption of the rule amendments in this release. For a list of changes to the Codification resulting from the rule amendments, see infra Section IX.

[37] See, e.g., Testimony of Laurence H. Meyer, Governor, Board of Governors of the Federal Reserve System (Sept. 13, 2000) ("High quality accounting standards . . . can potentially be nullified if there is a perception that auditors lack independence and objectivity in their enforcement role * * * I think if the perception didn't have any basis in reality, it would not necessarily last very long, so there has to be some interconnection between them, but the perception is an important one."); Testimony of David A. Brown, QC, Chair, Ontario Securities Commission (Sept. 13, 2000) ("The reality of independence is difficult, if not impossible. Perceptions of independence, therefore, become almost equal to reality in importance."); Testimony of Kayla Gillan, General Counsel, CalPERS (Sept. 13, 2000) ("It's not only the reality of biased auditing, but also the perception that a biased practice is possible that erodes investor confidence.").

[38] AICPA SAS No. 1, AU § 220.03. As explained in SAS No. 1, "Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence." See also Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 13, 2000) ("[The AICPA] believe[s] that appearances are very important and capital markets require confidence in financial statements and audit reports, and the member firms of the AICPA are basing their business of auditing on their reputations, and that is heavily affected by appearance. There is no question about that. We are not disputing that appearance is important."); Public Oversight Board ("POB"), Scope of Services by CPA Firms, at 27 (Mar. 1979) ("1979 POB Report") (citing A. Arens and J. Loebbecke, Auditing: An Integrated Approach (Prentice-Hall 1976)) ("[The appearance of independence is] a key ingredient to the value of the audit function, since users of audit reports must be able to rely on the independent auditor. If they perceive that there is a lack of independence, whether or not such a deficiency exists, much of that value is lost."); Earnscliffe Research and Communications ("Earnscliffe"), Report to the United States Independence Board: Research into Perceptions of Auditor Independence and Objectivity -- Phase II, at 11 (July 2000) ("Earnscliffe II") ("Perhaps the most overwhelming consensus was the belief that the perception of auditor independence is as critical to the integrity of the financial

system, as is the reality.").

[39] United States v. Arthur Young and Co., 465 U.S. 805, 819 n.15 (1984) (emphasis in original). See also Article IV of the AICPA's Standards of Professional Conduct, which provides, "Objectivity is a state of mind . . . . Independence precludes relationships that may appear to impair a member's objectivity . . . ." AICPA Code of Professional Conduct, ET § 55.01 (emphasis added). Elsewhere, the AICPA's SAS No. 1 states that auditors should "avoid situations that may lead outsiders to doubt their independence." SAS No. 1, AU § 220.03 (emphasis added).

[40] See Codification § 601.01.

[41] Belverd E. Needles, Jr. (ed.) Comparative International Accounting Standards 26 (1985) (comparing France, Netherlands, Switzerland, U.K., Germany, Jordan, Kuwait, Canada, Mexico, U.S., and Japan).

[42] Institute of Chartered Accountants of Ontario, Rules of Professional Conduct Rule 204.1 (Objectivity: audit engagements); see also Institute of Chartered Accountants of British Columbia, Rules of Professional Conduct. Rule 204.1, Objectivity - Assurance and Specified Auditing Procedure Engagements.

[43] Testimony of David A. Brown, QC, Chair, Ontario Securities Commission (Sept. 13, 2000). Principles in Hong Kong regarding the conduct of accountants provide that "a member must at all times perform his work objectively and impartially and free from influence by any consideration which might appear to be in conflict with this requirement." Hong Kong Society of Accountants, Fundamental Principles ¶ 10 (revised April 1999). In addition, a Statement of Professional Ethics in that country provides that an auditor "should be, and be seen to be, free in each professional assignment he undertakes of any interest which might detract from objectivity." Hong Kong Society of Accountants, Statement 1.203, Professional Ethics (Integrity, Objectivity and Independence) ¶ 2 (revised June 2000).

[44] Letter of Helene Bon, President, Federation of European Accountants (Sept. 25, 2000).

[45] In 1998, the European Parliament approved a resolution broadly supporting the Green Paper. Green Paper, The Role, The Position and the Liability of the Statutory Auditor Within the European Union § 4.8 (July 24, 1996), available at http://europa.eu.int. Communication from the Commission, The Statutory Audit in the European Union: The Way Forward (May 7, 1998), C143 8.05.1988-EN, available at http://europa.eu.int.

[46] See infra Section IV.C.

[47] Some firms are seeking to provide expanded services through joint ventures with audit clients or their affiliates. As noted above, as early as 1988, large public accounting firms were looking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. See Letter from Jonathan G. Katz to Duane R. Kullberg, Arthur Andersen & Co. (Feb. 14, 1989).

[48] See Proposing Release, App. A, for a list of services that auditors provide to their audit and non-audit clients. The list was prepared by the ISB. See also Beverly Gordon, "KPMG spies

rapid growth in `shared services,'" Accounting Today, at 12 (June 3, 1996); "KPMG Restructures to Reposition Outsourcing," Public Accounting Report, at 1 (May 15, 1996); websites of Deloitte & Touche (http://www.deloitte.com) and KPMG (http://www.us.kpmg.com).

[49] Management advisory services ("MAS") are a subset of non-audit services.

[50] See Proposing Release, Table 1 in Appendix B. The underlying data are derived from data in "Special Supplement: Annual Survey of National Accounting Firms - 2000," Public Accounting Report (Mar. 31, 2000), annual reports filed with the AICPA Division for CPA Firms by public accounting firms, and from reports prepared by the AICPA Division for CPA firms.

[51] See Proposing Release, Tables 1 and 2 in Appendix B.

[52] See Proposing Release, Table 2 in Appendix B.

[53] See Proposing Release, Table 1 in Appendix B.

[54] See Proposing Release, Table 3 in Appendix B.

[55] Id.

[56] Id.

[57] See Proposing Release, Table 4 in Appendix B.

[58] See Proposing Release, Table 3 in Appendix B. Taken together, the data from Tables 1, 3, and 4 indicate that in 1999 more than 12,700 clients of the five largest public accounting firms paid approximately $9.150 billion for accounting and auditing services.

[59] See, e.g., Rick Telberg, "Anybody can do it! says small-firm consolidator," Accounting Today, at 5 (Jan. 4-24, 1999).

[60] "Done Deal: HRB acquires M&P for $240 million cash, pension obligation," Public Accounting Report, at 1 (July 15, 1999); "AmEx and Checkers Close The Deal," Public Accounting Report, at 1 (Mar. 31, 1997).

[61] "Cap Gemini and Ernst & Young Have Agreed to Terms for the Acquisition of Ernst & Young Consulting" (Feb. 29, 2000) (press release of Ernst & Young).

[62] As clarified by the amended S-1 filed by KPMG Consulting, Inc., in connection with the initial public offering, Cisco may sell up to about half of its stake in that entity. See KPMG Consulting, Inc., Form S-1, Amend. No. 3 (Sept. 25, 2000).

[63] Id.

[64] Albert B. Crenshaw, "Audit Firm Sells Consulting Unit," Wash. Post, Oct. 26, 2000, at E2; see also news release at www.grantthornton.com/esannounce/index.html.

[65] See Earnscliffe, Report to the United States Independence Board: Research into Perceptions of Auditor Independence and Objectivity ("Earnscliffe I") at 16 (Nov. 1999) (finding increased pressure and threat of earnings management in the technology sector); see also Testimony of Jay

W. Eisenhofer, Partner, Grant & Eisenhofer (Sept. 13, 2000) ("[I]n the current environment where company stock prices are increasingly dependent on showing growth and on meeting or exceeding the expectations of Wall Street investment analysts [, e]ven one missed profit number can have a significant negative effect on stock price. This places great pressure on company executives to insure that each quarter the profits are in the expected range, regardless of whether the quarter has been as good as the analyst expected. In order to meet these expectations, we often find that corporations will sometimes make questionable assumptions.").

[66] Ann Grimes, "Former McKesson Officials are Charged," Wall St. J., at B6 (Sept. 29, 2000); Sarah Schafer and David S. Hilzenrath, "Orbital to Settle Shareholder Suit," Wash. Post, at E1 (July 18, 2000); Paul Sweeney, "Accounting Fraud: Learning from the Wrongs," Fin. Exec. (Sept./Oct. 2000); Mike McNamee, "Accounting Wars," Bus. Wk., 157, 160 (Sept. 25, 2000); Bernard Condon, "Pick a Number, Any Number, Forbes (Mar. 23, 1998).

[67] See O'Malley Panel Report, supra note 20, ¶ 1.10 ("The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet `street' expectations . . . . These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients.").

[68] See supra notes 21-23.

[69] See Proposing Release, Section II.C.2; O'Malley Panel Report, supra note 20, at App. D (chronicling the debate since 1957); The Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations 95-96 (1978). See also infra notes 92, 98 (citing recent studies).

[70] Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. On Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (Comm. Print Nov. 1977). In the Report, the Subcommittee stated that it "agrees with the Cohen Commission and many others that the accounting profession must improve its procedures for assuring independence in view of the public's needs and expectations. Several activities of independent auditors have raised questions. Among them are public advocacy on behalf of a client, receiving gifts and discounts from clients, and maintaining relationships that detract from the appearance of arm's-length dealings with clients. Such activities are not appropriate." Id. at 16. The Subcommittee also stated that "[t]he best policy . . . is to require that independent auditors of publicly owned corporations perform only services directly related to accounting. Non-accounting management services . . . should be discontinued." Id. at 16-17. In a letter to Harold Williams, Chairman, SEC, Senator Thomas F. Eagleton, Chairman, Subcomm. on Governmental Efficiency and the District of Columbia, of the Senate Comm. on Governmental Affairs, recommended that "[t]here must be a requirement that independent auditors of publicly owned corporations perform only services directly related to accounting." Letter from Senator Thomas F. Eagleton to Harold Williams (Apr. 6, 1978) (attached list of recommendations) (reprinted in Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role (July 1978)).

[71] Letter from John J. McCloy, Chairman, POB (former Chairman of the Board of Chase

Manhattan Bank and former President of The World Bank), to Walter E. Hanson, Chairman, Executive Committee, SECPS (Mar. 9, 1979).

[72] Special Committee on Financial Reporting, AICPA, Improving Business Reporting - A Customer Focus: Meeting the Information Needs of Investors and Creditors, at 104 (1994).

[73] Advisory Panel on Auditor Independence, Strengthening the Professionalism of the Independent Auditor: Report to the Public Oversight Board of the SEC Practice Section, AICPA, at 9 (Sept. 13, 1994).

[74] Office of the Chief Accountant, SEC, Staff Report on Auditor Independence (Mar. 1994) ("Staff Report"). Between 1979 and 1981, public companies were required to disclose in their proxy statements certain information about non-audit services provided by their auditors. See infra Section IV.G. (discussing these disclosure requirements).

[75] See Staff Report, supra note 74, at 84; Proposing Release, notes 40-42.

[76] GAO, THE ACCOUNTING PROFESSION - Major Issues: Progress and Concerns, at 8 (GAO/AIMD-96-98, Sept. 1996).

[77] See supra Section III.B.; Proposing Release, Section II.C.2(b).

[78] See, e.g., Testimony of Kayla Gillan, General Counsel, CalPERS (Sept. 13, 2000) ("The concept that an auditor who has a greater financial incentive to please management than to criticize it will tend to find ways to avoid negative comment is intuitive and obvious."); Letter of B. Raymond Dunham ("I understand that actual hard evidence may not be apparent on the surface. However, it becomes obvious that auditing judgment may be clouded when large sums of potential revenues are dependent upon an auditing decision from any firm that derives great revenues from consulting services to the same organizations it is responsible for auditing. . . . The separation of consulting and auditing is intuitive if a firm is to maintain independence in its auditing procedures."); Letter of David T. DeMonte, CPA ("The conflict of interest potential is so patently obvious.").

[79] See, e.g., Testimony of Thomas C. DeFazio, Executive Vice President and Chief Financial Officer, VirtualCom, Inc. (Sept. 13, 2000) ("[T]he provision of non-audit services does not pressure the audit firms to look the other way."); Testimony of Thomas M. Rowland, Senior Vice President, Fund Business Management Group, Capital Research & Management Co. (Sept. 20, 2000) ("[A]t no time during my career did I feel pressure from other partners in the firm . . . not to do the right thing.").

[80] See, e.g., Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 21, 2000).

[81] See, e.g., Letter of Financial Accounting Standards Committee, American Accounting Association (Oct. 12, 2000),

[82] See O'Malley Panel Report, supra note 20, ¶ 4.4 at 99 ("Focus group participants often indicated that not only clients, but also engagement partners and firm leaders, treat the audit negatively - as a commodity.").

[83] AICPA Practice Aid Series, Make Audits Pay: Leveraging the Audit Into Consulting Services,

at 3 (1999).

[84] Id. at 24.

[85] See, e.g., Letter of William S. Lerach, Milberg Weiss Bershad Hynes & Lerach LLP (Sept. 22, 2000) ("In some instances, public companies bid out auditing work demanding low bids, while indicating to the bidding firms that low auditing bids will be rewarded with lucrative consulting work"). Texas adopted a statutory provision to prevent the use of audits as loss leaders in order to protect small audit firms that could not compete in a market where audits were underpriced. Tex. Rev. Civ. Stat. art. 41a-1, § 20A (1994). See also Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Accountancy (Sept. 20, 2000) (explaining that the worry was that "big firms would predatory price their way into markets and . . . in effect, gain a competitive advantage over smaller firms that couldn't discount their work to the same extent"); Written Testimony of Wanda Lorenz, CPA, Lane Gorman Trubitt (Sept. 20, 2000) ("[M]ost of the problems that exist today can be tied to fee negotiations on audits. . . . Therefore the profession has accepted being bargained with like a shopkeeper in some bazaar in order to perform other more lucrative work.") (emphasis in original).

[86] See Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000) ("Audit failures occur because auditors become careless and in the oversight or reliance on something, they may be taking a shortcut. Clearly, where an audit is low bid, there is that concern.").

[87] Low-balling also sends a message to the auditor that the audit relationship is not as valuable as the consulting relationship. See Testimony of Roderick Hills, former Chairman, SEC (Sept. 20, 2000). Low-balling sends a message inside the audit firm as well. We are concerned that the shift in a firm's emphasis away from auditing and toward non-audit services causes, over time, a cultural shift within the firm. The factors that drive a high quality audit, including the core values of the auditing profession, may diminish in importance to the firm, as will the influence of those firm members who exemplified those core values in their own professional careers.

[88] Testimony of Professor John C. Coffee, Jr., Columbia University (July 26, 2000) ("[T]he expected costs facing the accountant who might be []tempted to shirk his duties in order to please management have vastly declined in just the last five or six years."); see also Written Testimony of Professor Coffee.

[89] Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of the U.S.C.) (requiring most private class actions alleging fraud in the sale of nationally traded securities to be based on federal law and brought in federal court).

[90] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[91] The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, amended 18 U.S.C. § 1964(c) to eliminate "fraud in the purchase or sale of securities" as a predicate act for RICO liability unless the defendant has been criminally convicted.

[92] AICPA Letter (citing AICPA, Serving the Public Interest: A New Conceptual Framework for Auditor Independence (Oct. 20, 1997) ("AICPA White Paper")). We note that the data relied on in the AICPA White Paper and referred to in the AICPA Letter was collected in 1997. As we

discuss throughout this release, the magnitude of non-audit services has increased dramatically over the past several years.

[93] See Testimony of Professor Max H. Bazerman, Northwestern University (July 26, 2000); Testimony of Professor George F. Loewenstein, Carnegie Mellon Institute (July 26, 2000); see also Max H. Bazerman, Kimberly P. Morgan, and George F. Loewenstein, "The Impossibility of Auditor Independence," Sloan Management Review at 91, 94 (Summer 1997) (reviewing empirical research showing that "[w]hen people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self interest," and concluding that, despite their best intentions, "there is good reason to believe that auditors will unknowingly misrepresent facts and will unknowingly subordinate their judgment due to cognitive limitations"); Jesse D. Beeler and James E Hunton, "Contingent Economic Rents; Insidious Threats to Auditor Independence," manuscript (2000).

[94] Testimony of Don N. Kleinmuntz, Professor, University of Illinois at Urbana-Champaign (Sept. 21, 2000); Testimony of Urton Anderson, Professor, University of Texas at Austin (Sept. 21, 2000) (presenting results of research commissioned by Arthur Andersen, Deloitte & Touche, KPMG, and the AICPA); see also Testimony of Professor Rick Antle, Yale University (July 26, 2000) (researcher for the AICPA presenting personal views on data).

[95] See supra notes 88-91.

[96] See infra Section III.C.5.

[97] At least one witness challenged the effectiveness of the current peer review system. She testified that, as enacted, peer review has no "teeth." Testimony of Wanda Lorenz, CPA, Lane Gorman Trubitt, LLP (Sept. 20, 2000).

[98] See, e.g., In the Matter of PricewaterhouseCoopers LLP, AAER No. 1098 (Jan. 14, 1999).

[99] W.R. Kinney, Jr., "Auditor Independence: Burdensome Constraint or Core Value?" Accounting Horizons (March 1999); G. Trompeter, "The effect of partner compensation schemes and generally accepting accounting principles on audit partner judgment," Auditing: A Journal of Practice and Theory (Fall 1994); Paul M. Clikeman, "Auditor Independence: Continuing Controversy," Ohio CPA Journal (Apr.-Jun. 1998).

[100] Earnscliffe II, supra note 38, at 6. Interviewees included chief executive officers, chief financial officers and controllers, auditors, buy-side and sell-aside analysts, audit committee chairs, and regulators.

[101] The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees noted with respect to independent directors that, even absent objective verification, "common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee"), Report and Recommendations, at 22 (1999) (the "Blue Ribbon Report"). Copies of the Blue Ribbon Report are available at www.nyse.com or www.nasd.com

[102] Written Testimony of John D. Hawke, Jr. (July 26, 2000).

[103] Written Testimony of Paul A. Volcker (September 13, 2000). Aggregate economic incentives aside, non-audit services can have the effect of aligning the accountant's interests with those of management. When the accountant acts as a consultant, the accountant must answer to management, and a "consultant . . . will be judged by the ultimate usefulness of his advice in bringing success to management's efforts. He has had a hand in shaping managerial decisions and will be judged by management on the same basis that the management itself will be judged." R.K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing at 222 (Am. Acct. Ass'n 1961). As the auditor becomes increasingly involved with the audit client and its managers, the auditor is more likely to perceive himself as a part of the management team and place less emphasis on his or her primary loyalty to investors. In Earnscliffe I, Earnscliffe reported that many individuals interviewed believed that pressures on auditors have been increasing and are becoming problematic, and that "auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders." Earnscliffe I, supra note 65, at 9.

[104] Earnscliffe I, supra note 65, at 46 (Nov. 1999). The study also found that many individuals interviewed believed that "auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders." Id. at 9.

[105] Earnscliffe II, supra note 38, at 5 (July 2000).

[106] The O'Malley Panel Report, supra note 20, at ¶ 5.20.

[107] Brand Finance plc, The future of audit - "Back to the Future," ch. 1 (June 2000).

[108] Id.

[109] Written Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000) (submitting survey). AIMR is a global, non-profit organization of investment professionals.

[110] The results were published by the A.J. Palumbo School of Business Administration at Duquesne University ("Duquesne Poll"). PricewaterhouseCoopers provided funding for the poll.

[111] The 800 adults had incomes greater than $50,000.

[112] Duquesne Poll, supra note 110, Question 12.

[113] Duquesne Poll, supra note 110, Question 13. The Poll also found that 37% of respondents thought the new rule was "somewhat important," 6% thought it "not very important," and 3% thought it "not at all important."

[114] Mr. Stadler is Dean of the John F. Donahue Graduate School of Business and the A.J. Palumbo School of Business Administration.

[115] For written comments, see, e.g., Letter of Samuel Fleishman (Sept. 9, 2000) ("My confidence in the audits is greatly decreased by knowing that the same company is or could be doing consulting work for the company they are auditing."); Letter of George R. Jensen (Sept. 8, 2000) ("Investors have a right to expect that sanctity [of the audit] as it is promised without having to

wonder about the same firm monkeying with the audit to preserve or enhance their consulting business."); Letter of Goran LindeOlsson (Sept. 9, 2000) ("The mere possibility that audits may not be 100% objective is reason enough to toughen the rules and keep accounting and consulting services separate."); Letter of Vivian D. Kilgore Jr. ("No public confidence should be given to any report of any firm that engages in this practice."); Letter of John Dossing (Sept. 10, 2000) ("Common sense tells me and other indivi[d]ual invest[o]rs this conflict of interests will lead to at the very least the appearance of conflict of interest. How can we trust any audits with the appearance of a conflict of interest. Why invest if we can't trust the figures presented to us in the financial statements?").

116 See Testimony of John H. Biggs, Chairman and CEO of TIAA-CREF (July 26, 2000); Testimony of Kayla J. Gillan, General Counsel, CalPERS (Sept. 13, 2000); Testimony of Alan P. Cleveland, New Hampshire Retirement System (Sept. 13, 2000); Testimony of Bill Patterson, Director, Office of Investment, AFL-CIO (Sept. 20, 2000).

117 Testimony of Paul A. Volcker (Sept. 13, 2000).

118 Written Testimony of Richard Blumenthal (Sept. 20, 2000).

119 Testimony of Manuel H. Johnson (July 26, 2000). See also Testimony of William T. Allen, Chairman, ISB (July 26, 2000) ("[T]he evolution of the auditing profession into multi-service professional firms has given rise to reasonable concerns that the integrity of financial data is being or may be adversely affected or at least that markets may become suspicious of that fact and impose an additional risk premium.").

120 Written Testimony of John H. Biggs before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Development (Sept. 28, 2000).

121 See, e.g., Testimony of John Guinan, Partner, KPMG (Sept. 13, 2000) ("There's no fundamental unease within the marketplace on this subject."); Testimony of Richard J. Stegemeier, Chairman Emeritus, Unocal Corp. (Sept. 13, 2000) ("I do not believe that [a clear and present danger to investors] exists.").

122 Earnscliffe I, supra note 65, at 8.

123 Earnscliffe II, supra note 38, at 44. At the request of the AICPA, Gary Orren, a professor at the John F. Kennedy School of Government, reviewed and evaluated Earnscliffe I and II. Memorandum from Gary Orren to AICPA (Sept. 19, 2000). Mr. Orren concluded that the findings do not support our proposals, and that the studies were methodologically flawed. At the same time, he acknowledged that among the respondents in the studies, "[a] larger number, about half, thought that a perception problem might develop in the future," that the majority of groups interviewed perceived a "slight appearance problem" today, that the respondents registered "mild misgivings" about the effects of non-audit services on independence, and that the respondents were "mildly worried" about a possible appearance problem in the future. Id. at 3, 4, and 7.

124 J. Gregory Jenkins and K. Krawczyk, North Carolina State University, Perceptions of the Relationship Between Nonaudit Services and Auditor Independence, manuscript (2000) (synopsis). In this study, the researchers interviewed 289 users of financial statements, including business professionals, graduate business students, and accounting professionals at Big Five

firms and Non-Big Five firms.

[125] Penn Schoen & Berland Associates, Inc., National Investors Survey (Sept. 12, 2000) ("Penn Schoen Survey").

[126] Id. at 4. What the Penn Schoen Survey did not report, but what we believe to be equally important, however, is that among all investors surveyed, only 54% said that they believe audited financial statements are "very credible," 37% believe they are only "somewhat credible," 5% believe they are "not credible," and the remaining 3% do not know if they are credible. See Judith Burns, "Investors Unconcerned About Auditor Independence," Dow Jones New Service (Sept. 12, 2000). We do not believe that investors or the accounting profession are well-served by a situation in which 37% of investors in a survey think public companies' audited financial statements are only "somewhat credible." In addition, according to the Penn Schoen Survey, 23% of investors surveyed believed that regulators should play a bigger role than they do now in prohibiting accounting firms from offering a range of services (id. at 10) and 33% of investors surveyed disagreed that if our rules proposals were implemented audit firms will know less about the companies they audit and the quality of the audit will suffer (id. at 13).

[127] Some have suggested that perception is not an appropriate basis for regulation. See AICPA White Paper, at App. A (paper by Gary Orren, "The Appearance Standard for Auditor Independence: What We Know and Should Know" (Oct. 20. 1997)). Others believe that "investor perceptions constitute an economically legitimate and theoretically sound basis for regulatory intervention." See, e.g., Written Testimony of Rajib Doogar (Sept. 20, 2000).

[128] See supra Section III.C.1; see also Arthur A. Schulte, Jr., "Compatibility of Management Consulting and Auditing," Accounting Rev. 586 (July 1965) (survey of four respondent groups - research and financial analysts of brokerage firms, commercial loan and trust officers of banks, investment officers of insurance companies, and investment officers of domestic mutual funds - indicated a third of all respondents believed that the provision of both audit and non-audit services was a conflict of interest); Abraham J. Briloff, "Old Myths and New Realities in Accountancy," Accounting Rev. 490-94 (July 1996) (finding that a significant number of academics, members of financial community, and accountants believed that an auditor's provision of management-advisory services detracted from the quality of the audit); Pierre L. Titard, "Independence and MAS - Opinions of Financial Statement Users," J. Accountancy 47 (July 1971) (finding that a significant number of parties who represented major investment concerns believed that an auditor's provision of management advisory services impaired auditor independence).

[129] Letter of Deloitte & Touche (Sept. 25, 2000) ("Deloitte & Touche Letter").

[130] In this regard, our rule addresses potential conflicts in a way that is similar to rules regarding the conduct of federal judges. For example, § 455 of title 28 of the federal code provides that a federal judge is to disqualify himself (and may be disqualified by the appellate court) in any proceeding where the judge's "impartiality might reasonably be questioned." 28 U.S.C. § 455(a). The courts have explained that "disqualification is required if a reasonable person who knew the circumstances would question the judge's impartiality, even though no actual bias or prejudice has been shown." Gray v. University of Arkansas, 883 F.2d 1394, 1398 (8th Cir. 1989).

[131] "The Ties That Bind Auditors," The Economist at 63 (Aug. 12, 2000) ("Usually there is a

train wreck or a stock market crash prompting this sort of radical legislation.").

[132] Notice of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business, Exchange Act Release No. 33482 (Jan. 14, 1994) [59 FR 3389]; see also "Exceptions to Rules 10b-6, 10b-7, and 10b-8 Under the Securities Exchange Act of 1934 for Distributions of Foreign Securities to Qualified Institutional Buyers, Securities Act Rel. No. 6999 (May 5, 1993) [58 FR 27686] ("Rules 10b-6, 10b-7, and 10b-8 (`Trading Rules') are prophylactic in nature and designed to protect investors purchasing a security in a distribution from paying a price that has been artificially influenced (i.e., raised or supported) by those persons who have the greatest incentive to engage in manipulative activity. Because the Trading Rules protect investors against artificial price movements, they promote the integrity of the pricing process and public confidence in the U.S. securities markets.").

[133] "Selective Disclosure and Insider Trading," Release No. 33-7881 (Aug. 15, 2000) [65 FR 51715].

[134] Id.

[135] 61 F.3d 938 (D.C. Cir. 1994).

[136] Id. at 945. Similarly, even in the First Amendment context of restrictions on campaign contributions, the Supreme Court has upheld the validity of prophylactic rules. Nixon v. Shrink Missouri Government, 528 U.S. 377 (2000) (relying on the seminal case of Buckley v. Valeo, 424 U.S. 1 (1976)).

[137] The widespread perception among sophisticated members of the financial community that non-audit services are jeopardizing audit reliability at the very least suggests that there is in fact a problem. Moreover, at least one published study has found a statistical link between the provision of non-audit services and the frequency of audit qualifications. Graeme Wines, "Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note," 34 Acc. & Fin. 76 (May 1994). The author analyzed the audit reports put out between 1980 and 1989 by 76 companies publicly listed on the Australian Stock Exchange. He found that "the auditors of companies not receiving an audit qualification of any type over the period derived a significantly higher proportion of their remuneration from non-audit services fees than the auditors of companies receiving at least one audit qualification." Id. at 76. While the author acknowledges that his research is by no means conclusive, it does corroborate the common-sense expectation that "auditors are less likely to qualify a given company's financials statements when higher levels of non-audit fees are derived." Id. at 83.

[138] See Testimony of Robert L. Ryan, CFO, Medtronic, Inc. (Sept. 20, 2000) ("[T]o my mind one of the most sacred things in the whole audit process is judgment. . . . [T]here is so much judgment that goes into a financial statement and I want to feel that if I'm sitting across from a partner . . . that audit is the primary thing . . . .").

[139] Richard C. Breeden, Roderick M. Hills, David S. Ruder and Harold M. Williams, Editorial, supra note 33.

[140] See, e.g., Written Testimony of J. Michael Cook, former Chairman and Chief Executive

Officer, Deloitte & Touche (July 26, 2000) ("I do not share the view that proof of such a linkage is the only appropriate basis for regulatory action. To the contrary, I believe that most independence rules today are the result of appearance-based rather than fact-based concerns. Further, I agree with the Commission that the absence of "proof" does not justify inaction, particularly when such evidence cannot be expected to be demonstrable."); Paul B.W. Miller, Ph.D., CPA, Professor, University of Colorado at Colorado Springs, and Paul R. Bahnson, "The Spirit of Accounting" (draft column to appear in Accounting Today, submitted as Addendum to Written Testimony of Paul Miller (July 31, 2000) ("[A]udit failure is the wrong factor to consider. . . . The issue is not whether the auditor can avoid catastrophic failure but whether the audit can increase the credibility of the statements enough to make investors perceive a lower risk of being misled."); Testimony of Robert E. Denham, Member, ISB (July 26, 2000) ("[I]t's a mistake to focus too much on the cases of major audit failure and try to draw lessons from whether independence played a role in those. . . . [T]he better question for guiding the Commission . . . is what set of rules is more likely to produce better accounting, better financial reporting in the ordinary circumstances of the good companies . . . .").

[141] See, e.g., SEC v. Jose Gomez, AAER No. 57 (May 8, 1985).

[142] See, e.g., SEC v. Christopher Bagdasarian and Sam White, AAER No. 825 (Sept. 26, 1996).

[143] Article IV of the AICPA's Code of Professional Conduct provides, "Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services." AICPA Code of Professional Conduct, ET § 55.01.

[144] 1979 POB Report, supra note 38, at 34 n.103. As the POB noted, "[T]he Board recognizes that the nonexistence of such evidence does not necessarily mean that there have not been instances where independence may have been impaired. Not all situations where an auditor's objectivity is compromised will result in a lawsuit." Id. at 35.

[145] While we considered testimony from our public hearings in evaluating the need for the rules as a matter of public policy, there was no fact finding with respect to particular cases and we have not reached any conclusions as to the presence or absence of securities law violations in cases discussed by witnesses.

[146] Testimony of Robert M. Morgenthau (Sept. 13, 2000).

[147] See Testimony of Jay W. Eisenhofer, Partner, Grant & Eisenhofer (Sept. 13, 2000) ("It's always difficult to prove [that the auditor was influenced by large consulting fees] as a certainty, but what you're attempting to do is to use that information to demonstrate that the auditor had a motive that in combination with other facts that you're able to elicit demonstrates that the auditor at least recklessly disregarded its obligations, if not intentionally did so.").

[148] Testimony of Charles R. Drott (Sept. 13, 2000).

[149] Testimony of Stuart Grant, Partner, Grant & Eisenhofer (Sept. 20, 2000). Mr. Grant testified at the request of his client, the Council of Institutional Investors, although he stated that he was

expressing his own views.

[150] Testimony of Jay W. Eisenhofer (Sept. 13, 2000).

[151] But see Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000) ("Even if there was some isolated case[s] in which non-audit services were found to be linked to audit failures that would not establish a proper basis for the drastic action proposed by this rule.").

[152] Written Testimony of Richard Blumenthal (Sept. 20, 2000).

[153] Letter of William S. Lerach (Sept. 22, 2000). See also Letter of Britton Davis (Aug. 14, 2000) ("I have witnessed several instances of `rolling over' on issues that affected our clients, for no other reason than the apparent conflict sticking to our guns would have caused (thus threatening our revenue stream)."); see also Testimony of Charles R. Drott, CPA, CFA (Sept. 13, 2000) ("My overall conclusion... has been that in most of the cases that I have been involved in, meaning at least 50 cases that I have been involved in regarding audit failures, that the underlying cause of most of these situations was compromised auditor independence. This involved auditors auditing their own work, acting as advocates for their clients, entering into improper business relationships with their clients, and acting as management for their clients.").

[154] Testimony of Jack T. Ciesielski, accounting analyst (July 26, 2000).

[155] See supra note 22.

[156] As discussed above and in the Proposing Release (Section II.C), there have been significant changes in the accounting profession and the provision of non-audit services since 1982, when we rescinded our previous proxy statement disclosure requirement regarding non-audit services. From 1978 to 1982, we required companies to include in their proxy statement disclosures about non-audit services provided by their auditors, including the percentage of the fees for all non-audit services compared to total audit fees and the percentage of the fee for each non-audit service compared to total audit fees ("Disclosure of Relationships with Independent Public Accountants," ASR No. 250 (June 29, 1978)). Although our concerns about the provision of consulting and other non-audit services remained unchanged, we later determined to rescind the proxy disclosure requirement ("Rescission of Certain Accounting Series Releases and Adoption of Amendments to Certain Rules of Regulation S-X Relating to Disclosure of Maturities of Long-Term Obligations," ASR No. 297 (Aug. 20, 1981)). Among other reasons, our review of proxy disclosures convinced us that accounting firms then, in contrast to now, were not providing extensive non-audit services to their audit clients. In addition, we noted that, even without the proxy statement requirement, investors had access to useful data provided to and made public by the SECPS. As discussed below, that data are no longer readily available.

[157] In particular, summarized information regarding the relationship between non-audit and audit fees is provided to the SECPS by its member firms. Until recently, the SECPS published aggregate information regarding the mix of services provided by an accounting firm to all of its clients. Investors, however, would be primarily interested in the receipt of non-audit services by the companies in which they invest.

[158] Earnscliffe II, supra note 38 at 9.

[159] Penn Schoen Survey, supra note 125, at 15.

[160] Id.

[161] See, e.g., Arthur Andersen Letter.

[162] Testimony of Jack Ciesielski, accounting analyst (July 26, 2000).

[163] Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investment, TIAA-CREF (Sept. 21, 2000).

[164] The New York Stock Exchange ("NYSE"), National Association of Securities Dealers, Inc. ("NASD"), and the American Stock Exchange ("AMEX") also changed their company listing standards to make it clear that the auditor is ultimately accountable to the board of directors and the audit committee, as opposed to management, and that the audit committee and the board of directors have the ultimate authority and responsibility to select, evaluate and, when appropriate, replace the auditor. See Order Approving Proposed Rule Change by the NASD, Exchange Act Rel. No. 42231, File No. SR-NASD-99-48 (Dec. 14, 1999); Order Approving Proposed Rule Change by the NYSE, Exchange Act Rel. No. 42233, File No. SR-NYSE-99-39 (Dec. 14, 1999); and Order Approving Proposed Rule Change by the AMEX, Exchange Act Rel. No. 42232, File No. SR-Amex-99-38 (Dec. 14, 1999).

[165] "Audit Committee Disclosure," Exchange Act Rel. No. 42266 (Dec. 22, 1999).

[166] In its report, the Blue Ribbon Committee noted that with respect to independent directors, even absent objective verification, "common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." Blue Ribbon Report, supra note 101, at 22.

[167] ISB Standard No. 1, "Independence Discussions with Audit Committees" (Jan. 1999). Copies of standards issued by the ISB are available on the ISB's website at www.cpaindependence.org.

[168] In a letter to the SECPS, ISB Chairman William Allen clarified the use of the auditor's judgment under the standard. He stated:

[I]n asking itself whether a fact or relationship is material in this setting the auditor may not rely on its professional judgment that such fact or relationship does not constitute an impairment of independence. Rather the auditor is to ask, in its informed good faith view, whether the members of the audit committee who represent reasonable investors, would regard the fact in question as bearing upon the board's judgment of auditor independence.

Letter from William T. Allen, Chairman, ISB, to Michael A. Conway, Chairman, Executive Committee, SECPS (Feb. 8, 1999). We believe that Chairman Allen's interpretation is appropriate.

[169] Blue Ribbon Report, supra note 101, at 40.

[170] See Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000) ("[I]t's the audit firm's responsibility to determine that they are independent. . . . [T]he

obligation is clearly on the auditor. The auditor cannot put that obligation off solely to the audit committee in any form or fashion. And even if the audit committee were to determine things were okay, the firm is still responsible to make an independent judgment that they are in fact independent.").

[171] See Testimony of John Whitehead, former Chairman, Goldman Sachs & Co. (Sept. 13, 2000).

[172] See, e.g., Testimony of Robert L. Ryan, Chief Financial Officer, Medtronic, Inc. (Sept. 20, 2000) ("We believe that we should continue to require our audit committees, who are in the best position to evaluate independence, to play an active role in this assessment process as the proposed rule changes outline.").

[173] Companies have differing approaches to hiring their auditors to provide non-audit services. For example, John H. Biggs testified that TIAA-CREF does not hire its auditors to provide non-audit services (Testimony of John H. Biggs (July 26, 2000)), while Judy Lewent, Senior Vice President and CFO, Merck & Co., Inc., testified that her company employs a set of principles and practices for determining whether to hire their auditors to provide non-audit services, such as rotating its lead auditor every five years and requiring the audit committee to approve each request to use the outside audit firm for non-audit services. She noted that the company's process for such determinations has resulted in the use of their audit firm for non-audit services only in limited circumstances (Testimony of Judy Lewent (Sept. 13, 2000)).

[174] O'Malley Panel Report, supra note 20, at ¶ 5.29.

[175] Id. at 116-17.

[176] See, e.g., Testimony of Philip D. Ameen, Chair, Committee on Corporate Reporting, FEI-CRR (Sept. 20, 2000); Letter of Caroline Rook, Acxiom Corp. (Sept. 7, 2000); Letter of Allen J. Krowe, retired Vice Chairman, Texaco, Inc. (Sept. 5, 2000).

[177] See, e.g., Testimony of Bill Patterson, Director of the Office of Investment, AFL-CIO (Sept. 20, 2000).

[178] See, e.g., AICPA Letter.

[179] Letter from Michael H. Sutton, Chief Accountant, SEC to William T. Allen, Chairman, ISB (Dec. 11, 1997), at 6-7 (attaching SEC Staff Analysis of AICPA White Paper).

[180] O'Malley Panel Report, supra note 20, at ¶ 5.11. But see Testimony of James E. Copeland, Chief Executive Officer of Deloitte & Touche (Sept. 20, 2000) (asserting that it is the overall competencies gained by providing non-audit services to audit clients and non-audit clients that improve the quality of audits).

[181] Written Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000). Scrivner also is a former partner of Arthur Andersen. See also Testimony of Thomas Goodkind, CPA (Sept. 13, 2000) ("I have rarely seen [a transference of knowledge] occur in my experience.").

[182] See Testimony of Stephen G. Butler, Chairman and Chief Executive Officer, KPMG (Sept. 21, 2000) ("[C]learly we don't believe that we will not be able to do a quality audit today in the

structure that we have," with KPMG having incorporated its consulting business and prepared for an initial public offering of that business). Auditors of course have a professional obligation to have the expertise required to perform quality audits, and during the audit process, to gather all the evidence needed to evaluate, test, and render an opinion on the client's financial statements. See, e.g., General Standard No. 1 of Generally Accepted Auditing Standards ("GAAS") ("The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor."); Standards of Field Work No. 3 of GAAS ("Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."). AU § 150.02. Where auditors do not have the requisite expertise in house, they can hire others outside the firm to provide the skills needed. As observed by Jack Ciesielski, "Auditors have always had to call in specialists when matters are outside their understanding." Testimony of Jack Ciesielski, accounting analyst (July 26, 2000). See also Testimony of John J. Costello, Senior Director of Litigation, Gursey, Schneider & Co., LLP (Sept. 20, 2000) ("[I]n my experience over the years, many times have we had to go and get an independent consultant that was not part of the firm . . . . It is not something that's new. It's been there for a long time and could be done again.").

[183] See Proposing Release, Table 3 in Appendix B.

[184] Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000). See also Written Testimony of Philip A. Laskawy, Chairman, Ernst & Young (Sept. 20, 2000) ("[T]he argument that you have to have 30,000 consultants to do an audit is not real, it never was real, because . . . what percentage of clients are you doing consulting for and it is usually in the 20 to 30 percent range. So, the other 70 percent, I hope, are getting good audits.").

[185] Written Testimony of Philip A. Laskawy, Chairman, Ernst & Young (Sept. 20, 2000).

[186] See, e.g., KPMG Letter; Deloitte & Touche Letter; Arthur Andersen Letter.

[187] O'Malley Panel Report, supra note 20, at ¶ 5.18. Some of the eight members of the Panel, however, issued a separate statement calling for an outright ban (with very limited exceptions) on auditors providing non-audit services to audit clients because of their belief in the "central importance of independence to the profession of auditing in general, and to the effectiveness of the audit process in particular," and "the severe and growing challenges to independence that the audit profession faces in the current environment." Id., ¶ 5.32.

[188] Written Testimony of Laurence H. Meyer (Sept. 13, 2000). Moreover, it has been suggested that these efficiencies can "be partially appropriated as rents to the CPA firm supplier, and hence can themselves create a threat to independence." Dan A. Simunic, "Auditing, Consulting, and Auditor Independence," 22 J. Accounting Research 679, 681 (Autumn 1984).

[189] E.g., Letter of Ronald J. Marek, CPA (Aug. 17, 2000) ("Over the past twenty to thirty years, the big accounting firms started placing a higher value on selling skills and less on being `a good accountant.' This change is appropriate if the goal is generating more fees. This change has resulted in a deterioration of audit quality."); Letter of Mike McDaniel, CPA (Aug. 14, 2000) ("[T]he focus was sharper and firm operations had many fewer conflicts during the period when consulting services were not a central profit center for the Firms.").

[190] See Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("What is necessary to maintain audit quality is a sustained focus and investment in the audit profession rather than in non-audit services in order to keep up with the complexity and sophistication of business in a rapidly changing environment.").

[191] See, e.g., Letter of John L. Marty, CPA (Sept. 9, 2000) ("If the practice of `cross-selling' of services were constrained, it may cause a renewed emphasis on effective auditing and thereby, enhance the reliability of audited financial statements and protect the investing public."); Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000) ("Partners are measured by the amount of business that they generate, the referrals that they bring in, and the jobs that they handle. Obviously, their ability to generate more fees has a direct relationship in many of these firms, including my own, to their compensation."); Testimony of Wanda Lorenz, CPA, Lane Gorman Trubitt, LLP (Sept. 20, 2000) (acknowledging the "pressure on [audit partners] to sell - pressure on them to retain the client, pressure on them to build fees").

[192] O'Malley Panel Report, supra note 20, ¶ 4.4.

[193] O'Malley Panel Report, supra note 20, ¶ 5.23. See also Testimony of Jack Ciesielski, accounting analyst (July 26, 2000) ("[The] accounting profession . . . increasingly seeks to distance itself from the public image as auditor in favor of one that positions accountants in the public's collective mind as business enhancing consultants.").

[194] Testimony of Robert Fox, Chair, New York State Board of Public Accountancy (Sept. 13, 2000).

[195] See Testimony of Paul Volcker, former Chairman, Board of Governors of the Federal Reserve System (Sept. 13, 2000) ("I suspect that many of the traditional professions are feeling under some pressure from the lure of Wall Street incomes, and the dot com world, and I suspect the Federal Reserve feels that, and auditing firms feel it. It is a fact of life. I don't think you cure that problem by creating a conflict of interest in your own firm.").

[196] See supra note 53.

[197] U.S. Census Bureau, Statistical Abstract of the United States: The National Data Book (119th ed. 1999).

[198] Taylor Research & Consulting Group Study (2000) (commissioned by the AICPA); see generally AICPA Letter (noting trend); see also Letter of W. Steve Albrecht, Professor and Associate Dean, Marriott School of Management, Brigham Young University (Aug. 29, 2000) (noting trends and expressing concern that the proposal regarding non-audit services would cause "further and dramatic declines in the quality and quantity of students wanting to become accountants and auditors" because the accounting field will be narrower).

[199] In the 1991-1992 academic school year, the firms hired 22,520 graduates with bachelor and master degrees in accounting. In 1995-1996, that number had fallen to 20,470. AICPA: Supply/Demand Study 1997 ("AICPA Supply/Demand Study") presented to the O'Malley Panel (Aug. 31, 1999).

[200] See, e.g., Arthur Andersen Letter; KPMG Letter; Testimony of Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen (Sept. 20, 2000).

[201] See Testimony of David A. Brown, QC, Chair, Ontario Securities Commission (Sept. 13, 2000) ("[F]irms will continue to have difficulty recruiting new talent for the audit department, particularly if new recruits get a sense that other areas of the firm are more highly valued by firm management. . . . I think [the difficulty of recruiting on the audit side is] a very real issue, but I think the issue is clearly exacerbated by the messages being telegraphed to young recruits, and that is that there's a faster partnership track on the consulting side.").

[202] We also cannot overlook the extent to which the challenge of recruiting auditors partially may be a result of the firms' own business decisions. As the General Counsel of Andersen Consulting testified at our hearings, "Some of the firms have diverted investment and resources out of the audit function and into non-audit services, thereby reducing the attractiveness of the audit function as a career path." Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000); Letter of John S. Coppel, CPA, CFO, Electric Power Equipment Company (Aug. 16, 2000) ("Promising young staff are exiting the audit area, the professions['] most important training ground, after a[ss]essing accurately, that career growth opportunities lie elsewhere within the practice.").

[203] Testimony of Dennis Paul Spackman (Sept. 13, 2000).

[204] Id. ("The profession to a great extent is doing it to itself and it's doing it when it gives up audits in very competitive low ball kinds of bidding processes."); see also Testimony of Thomas Goodkind, CPA (Sept. 13, 2000) (stating, in response to a question from Chairman Levitt about why the profession is having a hard time recruiting auditors, "They're not offering enough money").

[205] W. Steve Albrecht & Robert J. Sack, Accounting Education: Charting the Course Through a Perilous Future 9 (Aug. 2000).

[206] Id. (showing that the number of accounting degrees awarded in the 1998-99 academic year declined 20% compared to those awarded in the 1995-96 academic year). There has been a general decline in students seeking bachelor degrees in business-related fields. See AICPA Supply Demand/Study 1997, supra note 199, which indicates that from 1992 to 1997, the number of students obtaining bachelor degrees in accounting declined by 14%, those obtaining finance degrees declined by 17%, those obtaining general business degrees declined by 8%, and those obtaining marketing degrees declined by 27%.

[207] O'Malley Panel Report, supra note 20, ¶¶ 8.9, 8.10.

[208] See Written Testimony of Testimony of Jack Ciesielski, accounting analyst (July 26, 2000); "Where Have All the Accountants Gone?" Bus. Wk., at 203 (Mar. 27, 2000) (noting that in addition to competition from corporations and startups and increasing college requirements, "also to blame, many are beginning to argue, are regulations that govern auditors' ability to invest in stocks," and that the firms "are having a much harder time addressing the biggest retention problem they face today: regulatory restrictions on stock ownership.").

[209] See generally Deloitte & Touche Letter.

[210] See supra Section III.B.

[211] Testimony of Stephen G. Butler, Chief Executive Officer, KPMG LLP (Sept. 21, 2000).

[212] Because we believed that it would have been useful to have additional data concerning the revenue mix of accounting firms, as well as the extent to which fees to audit clients for non-audit services exceed fees for audits, we solicited comment on revenue data. In addition, SEC Commissioner Isaac C. Hunt, Jr. informed the Big Five firms that these data would help the Commission in its deliberations. See Transcript of July 26 hearing for questions of Commissioner Isaac C. Hunt, Jr. posed to Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen LLP, Robert R. Garland, National Managing Partner, Assurance & Advisory Services, Deloitte & Touche, and J. Terry Strange, Global Managing Partner, Audit, KPMG LLP (July 26, 2000); see also Letters from Commissioner Isaac C. Hunt, Jr. to Joseph F. Berardino, Robert R. Garland, and J. Terry Strange (Aug. 18, 2000) and Letters from Commissioner Isaac C. Hunt, Jr. to Kenton J. Sicchitano, Global Managing Partner - Independence and Regulatory Affairs, PricewaterhouseCoopers LLP, and Mr. Robert Herdman, Vice Chair - AABS Professional Practice, Ernst & Young (Sept. 14, 2000). Counsel to Arthur Andersen LLP, Deloitte & Touche LLP and KPMG LLP indicated that some of these data might be provided by mid-September (Letter from John F. Olson, Gibson, Dunn & Crutcher LLP to Commissioner Isaac C. Hunt, Jr. (Sept. 1, 2000). However, no data were submitted by any of the five firms.

[213] See Albert B. Crenshaw, "Breakup of Andersen Firm Approved," Wash. Post, at E3 (Aug. 8, 2000) (quoting former Arthur Andersen Chief Executive James Wadia).

[214] See Proposing Release, Table 4 in Appendix B.

[215] See, e.g., Letter of Joseph F. Simontacci, CPA (Aug. 14, 2000); Letter of Leland D. O'Neal, CPA (Aug. 15, 2000); Letter of Danny M. Riddle, CPA (Aug. 16, 2000); Letter of Frank Chovanetz, CPA (Aug. 16, 2000).

[216] Letter of National Conference of CPA Practitioners (Sept. 25, 2000).

[217] Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000); see also Letter of John Mitchell, CPA (Aug. 14, 2000).

[218] See Testimony of Harold L. Monk, Jr., Chairman of the PCPS Executive Committee, AICPA (Sept. 21, 2000); Letter of Peter J. Hackett, Clark, Schaefer, Hackett & Co. (July 25, 2000); Letter of Frank P. Orlando (July 28, 2000); Letter of Michael L. Toms, York, Neel and Co. (Aug. 16, 2000).

[219] See, e.g., Testimony of Thomas J. Sadler, Past Chair, Washington State Board of Accountancy (Sept. 20, 2000); Letter of Mark A. Maurice, Chief Financial Officer, Avenir Group, Inc. (Aug. 15, 2000); Letter of Allan W. Nietzke, CPA (Sept. 23, 2000); Letter of Steven F. Farrel, CPA, ABV Gaither Rutherford & Co. LLP (Sept. 22, 2000); Letter of Honkamp Krueger and Co., P.C. (Sept. 22, 2000).

[220] See, e.g., Letter of Baxter Rice, President, California Board of Accountancy (Sept. 25, 2000);

Letter of James E. Houle, CPA, Chair, Oregon Board of Accountancy (Sept. 24, 2000).

[221] See, e.g., Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Public Accountancy (Sept. 20, 2000); Letter of William D. Baker, President, Arizona Board of Accountancy (Sept. 20, 2000).

[222] See Letter from Arthur Siegel, Executive Director, ISB (Aug. 31, 2000); Testimony of William T. Allen, John C. Bogle, Manuel H. Johnson, and Robert E. Denham (July 26, 2000).

[223] In this regard, we note that in FRR No. 50, we stated that we were not abdicating our responsibilities in this area and that our existing authority regarding auditor independence was not affected. ISB standards and interpretations do not take precedence over our regulations or interpretations. See FRR No. 50 (Feb. 18, 1998). In FRR No. 50, we also stated that "[i]n view of the significance of auditor independence to investor confidence in the securities markets, the Commission also will review the operations of the ISB as necessary or appropriate and, within five years from the date the ISB was established, will evaluate whether this new independence framework serves the public interest and protects investors." Id. Some witnesses acknowledged that changes to the ISB structure, such as having a majority of public members, may benefit the process and enhance the public's perception of the Board as a body focused on the public interest and protecting investors. See e.g., Testimony of William T. Allen, Chairman of the ISB (July 26, 2000) ("[I]informally we have discussed whether or not it would be desirable to increase the public membership of the board to a majority. I don't think it would [change] the outcome of our deliberations, but I recommended that we consider doing that on the notion that it might help the perception of the world, thinking that perhaps we were compromising to get standards done."); Testimony of Clarence Lockett, Vice President and Corporate Controller, Johnson & Johnson (Sept. 20, 2000) ("I believe that [having a majority of public members] would certainly go a long way in establishing that body in giving the appearance of greater independence from the profession of that body and its role in establishing independence."); Testimony of Philip A. Laskawy, Chairman, Ernst & Young (Sept. 20, 2000); Written Testimony of James J. Schiro, Chairman and Chief Executive Officer, PricewaterhouseCoopers (Sept. 20, 2000); Testimony of John J. Costello, Senior Director of Litigation, Gursey, Schneider & Co., LLP (Sept. 20, 2000); see also the Memorandum by Shaun O'Malley, Chair of the O'Malley Panel, to the O'Malley Panel, dated Aug. 31, 2000, identifying the expansion of the public representation on the ISB as a "major recommendation" of the Panel.

[224] See, e.g., KPMG Letter; AICPA Letter; Written Testimony of Philip D. Ameen, Philip B. Livingston, Roger W. Trupin, Financial Executives Institute (Sept. 20, 2000); Written Testimony of the New York State Society of Certified Public Accountants (Sept. 13, 2000).

[225] See, e.g., Letter of Kayla J. Gillan, General Counsel, CalPERS (Sept. 25, 2000) ("While CalPERS supports the work of the [ISB], only this Commission has the legal authority and effective ability to weigh the competing public interests that are represented in this area and reach conclusions about the best way to protect shareowners and the integrity of the financial markets.").

[226] ISB Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities," ¶ 5 (Dec. 1999).

[227] Testimony of William T. Allen, Chairman, ISB (July 26, 2000).

[228] Testimony of Robert E. Denham, Member, ISB (July 26, 2000).

[229] Written Testimony of Robert E. Denham (July 26, 2000).

[230] Testimony of Manuel H. Johnson, Member, ISB (July 26, 2000).

[231] During 1999, approximately 120 foreign companies from 26 countries entered our markets for the first time. At year-end, there were over 1,200 foreign companies from 57 countries filing reports with us, and public offerings by foreign companies totaled over $244 billion. SEC, Annual Report, at 76 (1999).

[232] IOSCO is an association of securities regulatory organizations and has over 100 members. See IOSCO Annual Report (1999), App. III.

[233] IOSCO, Press Release, IASC Standards (May 17, 2000), available at www.iosco.org/iosco.html.

[234] "International Accounting Standards," Securities Act Rel. No. 7801 (Feb. 16, 2000) [65 FR 8,896].

[235] "International Disclosure Standards," Exchange Act Rel. No. 41936 (Sept. 28, 1999) [64 FR 53,900].

[236] The Institute of Management Accountants, the AICPA, and the National Association of State Boards of Accountancy are members of IFAC.

[237] IFAC Ethics Committee, Independence: Proposed Changes to the Code of Ethics for Professional Accountants (Exposure Draft: Sept. 15, 2000).

[238] See, e.g., Letter of Horst Kaminski, German Institut der Wirtschaftsprufer (Institute of Certified Public Accountants) (Sept. 18, 2000); Letter of Ernst & Young (UK practice) (Sept. 7, 2000); Testimony of Jack Maurice, Member of Ethics Working Party, Federation des Experts Comptables Europeens (Sept. 21, 2000).

[239] See, e.g., Letter of Mike Rake, Chairman, KPMG Europe (Sept. 22, 2000); Letter of Ernst & Young (UK practice) (Sept. 7, 2000).

[240] See Letter from Phillipe Danjou, COB, to Lynn Turner, Chief Accountant, SEC (Oct. 10, 2000) ("I can assure you that many regulators in Europe (mainly continental Europe) do not agree with FEE's [conceptual] approach and have made their views known to the European commission when it started its consultation on the proposed Recommendations on statutory auditors' independence. I wrote a letter to Karel Van Hulle, Head of Unit, European Commission, to make clear that COB is not ready to accept a purely conceptual system without clear prohibitions.").

[241] Id. (noting that France, Germany, Italy, Spain, Belgium and others presently have a system based primarily on specific prohibitions of non-audit services, with exceptions for special circumstances). See also Letter from Michel Prada, President, COB, to Marilyn Pendergast, Chairman, Ethics Committee, IFAC (Sept. 15, 2000) (commenting on IFAC's Exposure Draft and noting that "we believe that the thrust of the exposure draft should be reversed from an

`allowed if . . .' system to a `forbidden except when . . .' system. The proposed change from a prescriptive approach to a framework approach is flawed by the absence of a clear definition of an auditor's unique role and position"). In Australia, securities regulators recently settled a case with one of the Big Five firms where the firm agreed to undertakings that restrict its ability to provide certain non-audit services. For example, one of the covenants is that the firm agreed not to "accept an audit engagement where [the firm] has valued an asset and the valuation is material to the audit engagement. The valuation constitutes a service which is a barrier to the firm's ability to provide an independent audit opinion on the client's financial statements." Media Release, Australia Securities and Investments Commission (Nov. 2, 2000), available at www.asic.gov.au. See also Staff Report, supra note 74, at Appendix II; Michael Firth, "The Provision of Nonaudit Services by Accounting Firms to their Audit Clients," Contemporary Accounting Research Vol. 14, No. 2, pp. 1-21 (Summer 1997). With respect to a recognized need by foreign regulators to take some type of regulatory action in this area, see Testimony of David A. Brown, Q.C., Chair, Ontario Securities Commission (Sept. 13, 2000) (noting that for over a year, the Ontario Securities Commission has publicly raised concerns about the issue of auditor independence, and that "[a]lthough we've not begun to frame a regulatory solution, it has become increasingly evident in Canada that some form of regulatory involvement in a solution will be essential.").

[242] See, e.g., Codification §§ 601.01 and 601.04.

[243] See, e.g., Codification § 602.02.c.i.

[244] See Rule 2-01(b), 17 CFR 210.2-01(b) (accountant cannot act as "director, officer or employee" of audit client and remain independent for purposes of Regulation S-X); Codification § 602.02.d.

[245] See, e.g., Arthur Young, 465 U.S. at 819 n.15; Codification §§ 602.02.e.i and ii.

[246] See supra note 15.

[247] See supra note 16; see also Written Testimony of Dan L. Goldwasser, Vedder, Price, Kaufman & Kammholz (July 26, 2000) (while acknowledging that "these concepts are not novel and can be found throughout the audit literature," stating that they "should not be adopted as guiding principles to be invoked each time a novel situation is encountered.").

[248] See, e.g., Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Accountancy (Sept. 20, 2000) ("[W]e would ask that [the four principles] be better placed in a preamble or a guidance document."); Testimony of Clarence E. Lockett, Vice President and Corporate Controller, Johnson & Johnson (Sept. 20, 2000) ("[W]e do not believe the four governing principles should be stated as firm rules [but rather] be part of the framework and serve [as] guiding principles.").

[249] Thomas D. Morgan and Ronald D. Rotunda, eds., The Model Code of Professional Responsibility (1995).

[250] Id. at Preliminary Statement (citing "Professional Responsibility: Report of the Joint Conference," 44 A.B.A.J., at 1159 (1958)).

[251] Federal Trade Commission, Rules and Regulations Under the Securities Act of 1933, art. 14

(July 6, 1933).

[252] Cf. Staff Report, supra note 74, at 12-16. See also SEC, Tenth Annual Report of the Securities and Exchange Commission, at 205-207 (1944), which states:

[T]he Commission has found an accountant to be lacking in independence with respect to a particular registrant if the relationships which exist between the accountant and the client are such as to create a reasonable doubt as to whether the accountant will or can have an impartial and objective judgment on the questions confronting him.

[253] See, e.g., KPMG Letter.

[254] See supra note 38-40; Proposing Release, Section II.B.

[255] See supra note 39.

[256] See United States v. Gamache, 156 F.3d 1, 8 (1st Cir. 1998) ("Now, undoubtedly, establishing intent, short of a situation in which it is admitted, is difficult and usually depends on the use of circumstantial evidence.").

[257] See TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (information is material if it would be "viewed by the reasonable investor as having significantly altered the `total mix' of information made available"); Basic, Inc. v. Levinson, 485 U.S. 224, 234-236 (1988).

[258] See also AICPA Code of Professional Conduct, ET § 101.02 (revised Feb. 28, 1998).

[259] Rule 2-01(f)(5) states that the engagement period ends when the registrant or accountant notifies the Commission that the registrant is no longer the accountant's audit client. This notice typically would occur when the registrant files with the Commission a Form 8-K with disclosures under Item 4 "Changes in Registrant's Certifying Accountant." In some cases, however, a Form 8-K is not required, such as when the registrant is a foreign private issuer or when the audited financial statements of a non-reporting company are filed upon its acquisition by a public company. Notification to the Commission in these cases would occur by the filing of the next audited financial statements of the foreign private issuer or the successor corporation. Registrants or auditors in these situations, however, may provide earlier notice to the Commission on Form 6-K or by other appropriate means.

[260] See AICPA SAS No. 1, AU § 220.03; AICPA Code of Professional Conduct, ET § 101. Of course, accountants also have to comply with applicable state law on independence. Id.

[261] AICPA SAS No. 1, AU § 220.03.

[262] Cf. AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 205 (2d Cir. 2000) (noting "E&Y's failure lay in the seeming spinelessness" of the audit engagement partner and that "[p]art of the problem was undoubtedly the close personal relationship between" that partner and the company's chief executive officer, a former co-partner in the firm) (quoting 991 F. Supp. 234, 248 (S.D.N.Y. 1997) (district court opinion)).

[263] A number of the specified situations are based on examples in the Codification and the AICPA and SECPS membership rules.

[264] See infra Sections IV.H.3 and IV.H.5, for detailed discussions of the definitions of "audit client" and "affiliate of the audit client." As explained below, the affiliates of the audit client that are deemed to be included in the term "audit client" for purposes of the financial relationship provisions in paragraph (c)(1)(i) are more limited than the group included in other parts of the rule.

[265] See, e.g., Written Testimony of Thomas M. Rowland, Senior Vice President, Fund Business Management Group, Capital Research and Management Company (Sept. 20, 2000) (restrictions should extend to persons in the firm beyond the scope of "covered persons"); Letter of John Spadafora (June 28, 2000) (narrowing the scope of persons whose investments are restricted "is another step backwards creating temptations to pass inside information to those whose investments are not restricted.").

[266] See generally Written Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000); Testimony of Ray J. Groves, former Chairman and Chief Executive Officer of Ernst & Young (July 26, 2000).

[267] See, e.g., Ernst & Young Letter.

[268] See, e.g., Written Testimony of William R. Kinney, Jr., Professor, University of Texas at Austin (Sept. 20, 2000) (proposed changes will "reduce aggregate regulatory compliance without affecting audit quality or increasing independence impairment risk for investors"); Testimony of Robert L. Ryan, Chief Financial Officer, Medtronic, Inc. (Sept. 20, 2000) (proposed financial relationship rules are "logical, less bureaucratic, and we're completely in agreement").

[269] See infra Section IV.H.9 for a detailed discussion of the definition of "covered persons in the firm."

[270] Proposing Release, Section III.C.1(a) citing Codification § 602.02.b.ii (Example 1).

[271] Proposing Release, Section III.C.1(a).

[272] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[273] 17 CFR 240.13d-101, 13d-102.

[274] Cf. Ernst & Young Letter; PricewaterhouseCoopers Letter (suggesting a similar provision for immediate family members of all partners in the firm).

[275] See Codification § 602.02.h (Examples 1 and 5).

[276] See former Rule 2-01(b).

[277] The analysis is different with respect to situations where the entity has a material investment in the audit client, or the audit client has a material investment in the entity. We address those situations in Rule 2-01(c)(1)(i)(E), discussed below.

[278] The term "diversified management investment company" refers to those entities meeting the definitions of "management company" and "diversified company" in Sections 4(3) and 5(b)(1) of the Investment Company Act, 15 U.S.C. §§ 80a-4(3) and 80a-5(b)(1).

[279] Under the Investment Company Act, a "diversified" management company must meet the following requirements: at least 75% of the value of its total assets is in cash, cash items, Government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater in value than five percent of the value of the total assets of such management company and not more than ten percent of the outstanding voting securities of such issuer. 15 U.S.C. § 80a-5(b)(1).

[280] One commenter recommended that diversification be measured under Subchapter M of the Internal Revenue Code rather than the Investment Company Act of 1940. See Letter of Investment Company Institute (Sept. 25, 2000) ("ICI Letter"). Under Subchapter M, at the end of each calendar quarter of the taxable year, at least 50% of the value of the fund's total assets must be represented by cash, cash items, U.S. Government securities, securities of other investment companies, and investments in other securities, which, with respect to any one issuer, do not represent more than five percent of the value of total assets of the fund or more than ten percent of the voting securities of the issuer. In addition, no more than 25% of the value of the fund's total assets may be invested in securities of any one issuer. The Commission determined not to adopt the tax code diversification test because an investment company could concentrate its investments in a smaller number of issues and requires diversification only at the close of each quarter.

[281] See Written Testimony of Thomas C. Rowland, Senior Vice President, Fund Business Management Group, Capital Research and Management Company (Sept. 20, 2000) (suggesting a similar rule).

[282] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[283] See AICPA Code of Professional Conduct, ET § 101-8.

[284] Here, as elsewhere in the rule, we use the term "significant influence" as it is used in Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" (Mar. 1971) ("APB No. 18"). See infra Section IV.H.3. Because we have included a specific rule on investments in non-clients, as well as the material indirect investment rule of paragraph (D), we have decided that a more limited definition of "affiliate of an audit client" is warranted for purposes of the investment rules in paragraph (c)(1)(i). The definition of "audit client" provides that, for purposes of paragraph (c)(1)(i), audit client does not include "entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of the section." In other words, the only "affiliates of the audit client" that are included in the term "audit client" in section (c)(1)(i) are those that are in a control relationship with the audit client or that are part of the same investment company complex as the audit client. The rules on investments specifically state that an investment in certain entities that significantly influence, or are significantly influenced by, the audit client, impair the auditor's independence. Accordingly, there is no need to include those entities within the more general definition of an "affiliate of the audit client."

[285] See Rule 2-01(c)(1)(i)(E)(1)(ii).

[286] Rule 2-01(c)(1)(i)(E)(3). The operation of paragraphs (E)(1)(ii) and (E)(3) is illustrated in the chart attached as Appendix A.

[287] Rule 2-01(c)(1)(i)(E)(1)(i).

[288] Rule 2-01(c)(1)(i)(E)(2). The operation of paragraphs (E)(1)(i) and (E)(2) is illustrated in the chart attached as Appendix B.

[289] Consistent with the Proposing Release, we have treated credit card debt as a separate category. See discussion of paragraph (c)(1)(ii)(E) below.

[290] Regulation S-X, Rule 1-02(r), 17 CFR 210.1-02(r).

[291] Regulation S-X, Rule 1-02(s)(2), 17 CFR 210.1-02(s)(2).

[292] See, e.g., Section 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p.

[293] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[294] See generally, Deloitte & Touche Letter.

[295] See Deloitte & Touche Letter (agreeing that such accounts "might, in certain circumstances, create a perception that an accounting firm's independence has been impaired").

[296] See, e.g., AICPA Letter.

[297] Letter of XL Capital Limited (Sept. 25, 2000); AICPA Letter; Letter of Swiss Re (Sept. 22, 2000).

[298] See AICPA Letter (suggesting this approach).

[299] See Rule 2-01(f)(4)(iv).

[300] ISB Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities," at ¶ 3 (Dec. 1999).

[301] See infra Section IV.H.11.

[302] See Letter of KPMG Europe (Sept. 22, 2000); Written Testimony of Institute of the Chartered Accountants in England & Whales ("ICAEW") (Sept. 13, 2000).

[303] See, e.g., ICI Letter; Deloitte & Touche Letter; see also Letter of the Association of Private Pension and Welfare Plans (Aug. 7, 2000).

[304] ICI Letter.

[305] See Letter from POB to ISB (Jan. 12, 2000) ("Public ownership in an audit firm or in its parent or in an entity that effectively has control of the audit firm would add another form of allegiance and accountability to those identified by the Supreme Court - a form of allegiance that in our opinion will be viewed as detracting from, if not conflicting with, the auditor's `public responsibility'").

[306] See AICPA Letter.

[307] See infra Section IV.H.2.

[308] See Written Testimony of William Travis, McGladrey & Pullen LLP (Sept. 20, 2000).

[309] See PricewaterhouseCoopers Letter ("We endorse and applaud the SEC's initiatives to modernize the archaic financial interest and employment rules in order to reflect today's social and business realities. We support, for the most part, the treatment of these topics in the Release.").

[310] See, e.g., Deloitte & Touche Letter; Letter of Steven Ryan, Chair, Financial Accounting Standards Committee, American Accounting Association (Oct. 12, 2000); Written Testimony of John C. Bogle, Public Member, ISB (July 26, 2000).

[311] See, e.g., AICPA Letter; Written Testimony of William T. Allen, Chair, ISB (July 26, 2000).

[312] See, e.g., Letter from Lynn E. Turner, Chief Accountant, SEC, to Charles A. Bowsher, Chairman, Public Oversight Board (Dec. 9, 1999); Letters from Lynn E. Turner, Chief Accountant, SEC, to Michael A. Conway, Chair, SECPS (Nov. 30, 1998; Dec. 9, 1999). These letters are available on our website.

[313] Nevertheless, we encourage, and we expect, firms to follow the steps described in ISB Standard No. 3, including the steps to be taken in the period after the firm's professional reports an intention to join an audit client and the steps to be taken after the professional actually joins the audit client. We also anticipate that peer reviews conducted by the POB will cover firms' compliance with these steps.

[314] These examples are illustrative only and should not be relied upon as a complete list of employment relationships that impair an accountant's independence under paragraphs (b) and (c)(2).

[315] Compare Letter of Paula Morris, MPA, CPA, Assistant Professor, Kennesaw State University (Sept. 25, 2000) (expressing her concerns about loosening the rules regarding spouses' and dependents' employment relationships) with Deloitte & Touche Letter (suggesting that an audit client's employment of a close family member of a covered person who is not on the audit engagement team or in the chain of command, should not be deemed to impair the auditor's independence, even if the person holds an accounting or financial reporting oversight role because there is only a "remote likelihood" that such a person could influence the audit).

[316] ISB, "Invitation to Comment 99-1: Family Relationships Between the Auditor and the Audit Client" (July 1999).

[317] AICPA Code of Professional Conduct, ET § 101.11.

[318] AICPA Letter ("For the most part, the specific positions listed in the definition . . . are appropriate and provide helpful advice to practitioners. . . . however . . . we do not believe the vice president of marketing should be included in this list."); Ernst & Young Letter.

[319] See, e.g., In the Matter of Jimmy L. Duckworth, CPA, AAER No. 1205 (Nov. 10, 1999); In the Matter of Pinnacle Micro, Inc., Scott A. Blum, and Lilia Craig, AAER No. 975 (Oct. 3, 1997).

[320] See AICPA, Auditing Standards Division, "Audit Risk Alert - 1994, General Update on

Economic, Accounting, and Auditing Matters," at 35 (1994).

A few litigation cases suggest auditors need to be more cautious in dealing with former coworkers employed by a client. None of these cases involved collusion or an intentional lack of objectivity. Nevertheless, if a close relationship previously existed between the auditor and a former colleague now employed by a client, the auditor must guard against being too trusting in his or her acceptance of representations about the entity's financial statements. Otherwise, the auditor may rely too heavily on the word of a former associate, overlooking that a common interest no longer exists.

[321] See Paul M. Clikeman, "Close revolving door between auditors, clients," Accounting Today, at 20 (July 8-28, 1996); Cf. In the Matter of Richard A. Knight, AAER No. 764 (Feb. 27, 1996) (individual allegedly learned of accounting misstatements while he was engagement partner for firm conducting audit and resigned to become registrant's executive vice president and chief financial officer).

[322] See, e.g., AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202 (2d Cir. 2000); AICPA Board of Directors, Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession, at 4 (June 1993) ("AICPA Board Report"); see also Staff Report, supra note 74, at 51-52; In addressing an example of this problem, the court in Lincoln S&L v. Wall, 743 F. Supp. 901, 917 n.23 (D.D.C. 1990) wrote:

Atchison, who was in charge of the Arthur Young audit of Lincoln, left Arthur Young to assume a high paying position with Lincoln. This certainly raises questions about Arthur Young's independence. Here a person in charge of the Lincoln audit resigned from the accounting firm and immediately became an employee of Lincoln. This practice of "changing sides" should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence. It would seem that some "cooling off period" perhaps, one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.

[323] In response to these and other concerns, the AICPA Board of Directors suggested in 1993 that we prohibit a public company from hiring the partner responsible for the audits of that company's financial statements for a minimum of one year after the partner ceases to serve that company. See AICPA Board Report, supra note 322, at 4. Our staff has indicated, however, that, if implemented, this suggestion would take the form of the firm's independence being impaired for a period of time from the date the individual left the audit engagement, rather than as a prohibition on hiring the former partner. Staff Report, supra note 74, at 52 n.146. See also Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), "Fraudulent Financial Reporting: 1987-1997: An Analysis of U.S. Public Companies," at 21 (1999) (finding, with respect to companies where there was fraudulent financial reporting, that among 44 companies for which there was information available on their CFO's background, 11% of the companies' CFOs had previous experience with the companies' audit firms just before joining the company).

[324] As noted in the Proposing Release, to avoid adverse tax consequences to the individual, accounting firms often settle their retirement obligations to former partners by fully funding a "rabbi trust" from which payments will be made to the individual. Under Rule 2-01(f)(16), a

"rabbi trust" is an irrevocable trust whose assets are not accessible to the firm until all benefit obligations have been met but are subject to claims of the firm's creditors in bankruptcy or insolvency. We are adopting the definition of "rabbi trust" as proposed.

[325] See, e.g., Written Testimony of ICAEW (Sept. 13, 2000).

[326] We would not consider an individual's 401(k) account to constitute a financial arrangement with the accounting firm to be fully funded for these purposes because, although the investment remains subject to market risk, the account balance is not dependent on the accounting firm's financial performance even if the firm continues to administer the account for the former firm personnel.

[327] With regard to cooling off periods, see AICPA Board Report, supra note 322, at 4 (June 1993) (suggesting that the Commission prohibit a public company from hiring the partner responsible for the audits of that company's financial statements for a minimum of one year after the partner ceases to serve that company) and Lincoln S&L v. Wall, 743 F. Supp. at 917 n.23 ("It would seem that some `cooling off period,' perhaps one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.").

[328] See, e.g., Letter of Pamela Roush, Ph.D., CMA (undated).

[329] See, e.g., Written Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000) ("We do not believe it is necessary to impose a mandatory `cooling-off period,' prohibit clients from hiring audit firm professionals, or stipulate that an audit firm's independence is impaired when its professionals accept key positions with current clients.").

[330] Nonetheless, we encourage firms to maintain adequate controls to ensure that former employees are not unduly influencing the audit engagement team.

[331] Of course, once an employee of an accounting firm, the person would also be subject to all other independence requirements applicable to other firm members. For example, if the former audit client employee becomes a covered person, he or she could have no financial interest in the audit client. See Rule 2-01(c)(1).

[332] The AICPA recommended that the rule apply to all professional employees of the accounting firm, not just to partners, shareholders, and principals. See AICPA Letter. We agree and, therefore, have modified the final rule to encompass this situation.

[333] See, e.g., Deloitte & Touche Letter; Written Testimony of Dennis Paul Spackman, Chairman, National Association of State Boards of Accountancy (Sept. 13, 2000) ("I am in full agreement with the provisions of the Commission's proposal [regarding] Business Relationships.").

[334] See Codification § 602.02.g.

[335] See Deloitte & Touche Letter ("Although we agree with the direction of [Rule 2-01(c)(3)], it provides no basis for prohibiting business relationships with beneficial owners of more than five percent of the equity securities of the audit client or any of its affiliates.").

[336] Ernst & Young Letter; see also AICPA Letter ("Such sweeping new restrictions would dramatically constrict the parties with which accounting firms could engage, even though many

such parties at most have only very attenuated ties to audit clients. . . . We view independence risks as extremely remote in such circumstances and, therefore, consider the reach of such provisions unnecessarily broad.").

[337] See Codification § 602.02.g; Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kulberg, Arthur Andersen & Co. (Feb. 14, 1989).

[338] See, e.g., Deloitte & Touche Letter.

[339] See infra Section IX; Codification § 602.02(g).

[340] See AICPA Letter.

[341] See Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kulberg, Arthur Andersen & Co. (Feb. 14, 1989).

[342] See, e.g., Proposing Release, Section III.D.1.(b)(i), (iv) (regarding bookkeeping and actuarial services, respectively). But see Proposing Release, Section III.D.1.(b)(ii) (regarding financial information systems).

[343] See, e.g., Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000).

[344] See Testimony of Joseph F. Berardino, Managing Partner, Assurance and Business Advisory Services, Arthur Andersen LLP (Sept. 20, 2000) and Testimony of James E. Copeland, Chief Executive Officer, Deloitte & Touche LLP (Sept. 20, 2000) (responding to questions from Chairman Arthur Levitt, SEC, about whether they would be comfortable if our final rules on non-audit services paralleled the profession's own rules); see also Testimony of K. Michael Conaway, Presiding Officer, Texas State Board of Accountancy (Sept. 20, 2000).

[345] See infra Section IV.D.4.b(x).

[346] AICPA Code of Professional Conduct, ET § 101.05; Codification § 602.02.c.i.

[347] Proposing Release, Section III.D.1(b)(i); Codification § 602.02.c.

[348] See, e.g., Deloitte & Touche Letter; AICPA Letter.

[349] See Ernst & Young Letter.

[350] For example, as part of the audit process, the auditor might propose adjustments that eventually are incorporated into the audit client's financial statements. See Deloitte & Touche Letter.

[351] AICPA Code of Professional Conduct, ET § 101.05.

[352] See, e.g., Deloitte & Touche Letter.

[353] Codification § 602.02.c.ii, Example 6.

[354] Codification § 602.02.c.iii.

[355] Proposing Release, note 160.

[356] Deloitte & Touche Letter; Ernst & Young Letter; PricewaterhouseCoopers Letter.

[357] There may be entities that are not large enough to maintain the capability in-house, yet there may not be reputable providers of these services where domestic companies' foreign affiliates are located or a reputable firm may not want to provide the services because they will generate only minimal fees. See Codification § 602.02.e.iii.

[358] Codification § 602.02.c.iii (requiring compliance with this condition, "so that an informed observer in the foreign location would have no cause to question the fact or appearance of independence").

[359] Codification § 602.02.c.iii.

[360] The Commission has determined to raise to $10,000 from $1,000 the dollar threshold in the Codification in light of the inflation since the provisions in the Codification were adopted.

[361] See generally, Arthur Andersen Letter; Deloitte & Touche Letter.

[362] See AICPA Code of Professional Conduct, ET § 101.05.

[363] Although we anticipate that accountants and their audit clients will usually seek to meet these conditions, we note certain points about paragraph (c)(4)(ii)(B) relevant to situations where these conditions are not met. First, by "significant," we refer to information that is reasonably likely to be material to the financial statements of the audit client. Since materiality determinations may not be final before financial statements are generated, an accounting firm may need to evaluate the general nature of the information rather than wait to evaluate system output during the period of the audit engagement. For example, without satisfying the conditions of paragraphs (c)(4)(ii)(B)(1)-(5), an accountant would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning ("ERP") system. (An ERP system is designed to integrate all functions and departments in a company into one computer system that can serve the needs of each department.) In addition, without satisfying the conditions, a firm's independence would be impaired if it designed and implemented an accounts receivable/order management system that recorded and summarized sales that were material to the financial statements of the audit client. A firm's independence would not be impaired, however, if the accounting firm designed and implemented a system for a foreign subsidiary whose financial condition and results of operations were not material to the financial statements of the audit client.

[364] Ernst & Young Letter; PricewaterhouseCoopers Letter.

[365] The ISB has identified threats to the independence of firms that perform appraisal and valuation services for audit clients. See ISB, Discussion Memorandum 99-3 "Appraisal and Valuation Services," at 7-9.

[366] See generally Codification § 602.02.c.

[367] See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter; PricewaterhouseCoopers Letter.

[368] Of course, reference to financial statements includes results of operations, financial conditions and cash flows.

[369] AICPA Code of Professional Conduct, ET § 101.05 states that an auditor's independence would not be impaired in connection with appraisal and valuation services "when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of the valuation."

[370] See, e.g., Arthur Andersen Letter.

[371] Deloitte & Touche Letter.

[372] We note in this regard, that if an acquisition individually, and when aggregated with other acquisitions reflected in the financial statements, is immaterial to the audit client's financial statements, then assisting in the allocation of the purchase price would not fall within the conditions of the rule and therefore would not be deemed to impair the auditor's independence.

[373] See, e.g., Deloitte & Touche Letter; Ernst & Young Letter; Letter of KPMG Europe (Sept. 22, 2000).

[374] Ernst & Young Letter.

[375] See e.g., Deloitte & Touche Letter; Letter of KPMG Europe (Sept. 22, 2000).

[376] See Letter from Lynn Turner, Chief Accountant, SEC, to Antonio Rosati, CONSOB (Aug. 24, 2000). In that letter, our Chief Accountant did not deem the auditor's independence to be impaired where there were certain agreed-upon procedures for the contribution-in-kind report and the accountant represented in the report that the report did not express an opinion on the fairness of the transaction, the value of the security, or the adequacy of consideration to shareholders. This letter is available on our website.

[377] SECPS Reference Manual ("SECPS Manual") § 1000.35.

[378] PricewaterhouseCooopers Letter; Ernst & Young Letter; see also Deloitte & Touche Letter.

[379] SECPS Manual § 1000.35, at ¶ 5.

[380] Although it addresses a different topic, accountants and registrants may refer to ISB, "Interpretation No. 99:1: Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)" for general guidance on what constitutes "assistance" as opposed to "performing" certain functions or services.

[381] See SECPS Manual § 1000.35.

[382] See Committee of Sponsoring Organizations of the Treadway Commission, Internal Control - Integrated Framework, at 7 (1992) (the "COSO Report").

[383] Testimony of Robert E. Denham (July 26, 2000); see also Testimony of John Whitehead, retired Chairman, Goldman Sachs & Co. (Sept. 13, 2000) ("internal auditing is the function of management").

[384] Testimony of Manuel H. Johnson, Public Member, ISB (July 26, 2000).

[385] See AICPA Code of Professional Conduct, ET § 101.15 (Interpretation 101-13).

[386] Testimony of John D. Hawke, Jr. (July 26, 2000). He also reported a trend among banks in favor of outsourcing internal audit work to the external auditor. He testified that "[o]f [the] 50 largest banks" within the jurisdiction of the OCC, "8 out-source their internal audit, and 7 of those 8 out-source to the same firm that does their external audit. That's a pretty good chunk of the largest banks." Id. In addition, Mr. Hawke reported that in a survey of the OCC banks in the Northeast region, one-third outsource their internal audit work and half of those banks outsource to their external auditor. Id.

[387] In this study, companies with small, "mean-sized," and large internal audit departments were asked to indicate their level of agreement (on a scale of zero to five, with five being the strongest) with the following statement: "There is an independence problem if the external audit firm performs extended audit services (internal audit services) for the same firm for which it performs the annual financial statement audit." The level of agreement among respondents was between 3.7 and 4.0, "indicating a perception of an independence problem." Larry E. Rittenberg and Mark A Covaleski, The Outsourcing Dilemma: What's Best for Internal Auditing, at 68 and Exh. 4-4 (Institute of Internal Auditors Research Foundation 1997).

[388] AICPA SAS No. 55, AU§ 319 (effective for audits on or after Jan. 1, 1990).

[389] See, e.g., Testimony of John D. Hawke, Jr., Comptroller of the Currency (July 26, 2000) (noting concerns about the effect of the proposed rule on small banks); Testimony of Wayne A. Kolins, National Director of Assurance, BDO Seidman, LLP (Sept. 20, 2000).

[390] These hardships could include, for example, difficulty in obtaining suitable professional services at a cost appropriate to the size of the business, or, for a small accounting firm, the loss of a substantial portion of its client base for either its audit or internal audit services.

[391] Using the $200 million threshold reasonably isolates companies that are relatively small themselves - approximately 54% of the 9,414 public reporting companies in the Standard & Poors Research Insight Compustat Database ("Compustat Database") - and has the effect of almost completely excepting smaller accounting firms. Approximately 85% of the public company audit clients (other than bank holding companies) of non-Big Five accounting firms have less than $200 million in assets. Of public company audit clients with more than $200 million in assets - the companies that would not trigger the exception - no more than 6.1% (again, excluding bank holding companies) are audited by non-Big Five firms. The source for these data is the Compustat Database, October 31, 2000. For further analysis, see infra Section V.B. (cost-benefit analysis).

[392] See, e.g., Testimony of Jacqueline Wagner (Sept. 13, 2000) (testifying for the Institute of Internal Auditors) ("The IIA believes that the total outsourcing of the internal auditing function to the organization's external auditing firm impairs that firm's independence."); Testimony of Dominick Esposito, Chief Executive Officer, Grant Thornton LLP (Sept. 13, 2000) ("I think if there is the entire internal audit department outsourced, it can present a conflict.").

[393] Testimony of Ray J. Groves (July 26, 2000).

[394] See AICPA Code of Professional Conduct, ET § 101.15 (Interpretation 101-13).

[395] Testimony of Barry Melancon, President and Chief Executive Officer (Sept. 13, 2000). Mr. Melancon also noted that "[t]here still has to be management responsibility for the overall internal audit function . . . we certainly agree that the ultimate responsibility for internal auditing, the management decision making, must [lie] with management, not with the auditor."

[396] When providing internal audit services to an audit client with $200 million or more in assets, the auditor must measure the internal audit services provided to the audit client in full-time employee hours. In order to remain independent, the auditor must ensure that it provides 40% or less of the total hours expended by the audit client, the auditor and anyone else on internal audit matters related to internal accounting controls, financial systems, and financial statements, and matters that impact the financial statements.

[397] In addition, performing procedures that generally are considered to be within the scope of the engagement for the audit of the audit client's financial statements, such as confirming accounts receivable and analyzing fluctuations in account balances, would not impair the accountant's independence, even if the extent of testing exceeds that required by GAAS. For example, if an accountant in normal circumstances would plan to observe ten percent of an audit client's inventory, but at the audit client's request the accountant observes 50% of inventory on hand, the accountant's independence would not be impaired.

[398] AICPA Code of Professional Conduct, ET § 101.15 (Interpretation 101-13).

[399] AICPA Code of Professional Conduct, ET § 191.206-207 (Interpretation 101-103).

[400] Former Rule 2-01(b), 17 C.F.R. 210.2-01(b); AICPA Code of Professional Conduct, ET § 101.02.

[401] See SECPS Manual § 1000.35 App. A; see also AICPA Code of Professional Conduct, ET § 101.05 (Interpretation 101-3) (deeming an auditor's independence impaired when the auditor negotiates employee compensation or benefits, or hires or terminates client employees).

[402] SECPS Manual § 1000.35 App. A.

[403] Id.

[404] Id.

[405] Id.; AICPA Code of Professional Conduct, ET § 101.05.

[406] Id.

[407] SECPS Manual § 1000.35 App. A

[408] See, e.g., Deloitte & Touche Letter; KPMG Letter; PricewaterhouseCoopers Letter; Ernst & Young Letter.

[409] See, e.g., KPMG Letter; Ernst & Young Letter.

[410] See, e.g., Deloitte & Touche Letter; Ernst & Young Letter.

[411] Former Rule 2-01(b), 17 CFR 210.2-01(b).

[412] Codification § 602.02.e.iii.

[413] See AICPA Code of Professional Conduct ET § 101.05.

[414] See, e.g., Ernst & Young Letter; PricewaterhouseCoopers Letter.

[415] See Arthur Andersen & Co., 1994 SEC No Act. LEXIS 617 (July 8, 1994) ("Andersen No-Action Letter") in which the staff stated it would not recommend enforcement action under the Investment Advisers Act where an accounting firm did not register as an investment adviser but an affiliated registered investment adviser provided investment advisory services. The staff permitted the affiliate to publish a newsletter with financial planning information, provided the newsletter does not recommend any specific industry sectors or securities, to identify categories of mutual funds that satisfy an advisory client's investment objectives, and to recommend two or more mutual funds in each category. When an advisory client wants more specific advice, the investment advisory affiliate accountant will provide a client with a list of two or more investment advisers or broker-dealers that meet certain predetermined criteria, provided that the accountant does not receive any fee or other economic benefit from the mutual funds, investment advisers or broker-dealers recommended. The advisory affiliate will disclose to advisory clients that the recommended mutual funds, investment advisers, or broker dealers may include audit clients. See also Ernst & Young Letter (citing Andersen No-Action Letter).

[416] AICPA Code of Professional Conduct, ET § 101.05 (Interpretation 101-3).

[417] Id.

[418] Codification § 602.02.e.iii.

[419] See Arthur Andersen Letter (acknowledging that it is appropriate to prohibit accountants from recommending any specific securities to audit clients and from recommending audit clients' securities to non-audit clients).

[420] See AICPA Code of Professional Conduct, ET § 101.05, Interpretation 101-3, which states that an accountant's independence would not be impaired if that accountant assists in developing corporate strategies, assists in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria, assists in analyzing the effects of proposed transactions, assists in drafting an offering document or memorandum, or participates in transaction negotiations in an advisory capacity.

[421] Letter from Edmund Coulson, Chief Accountant, SEC, to Edward McGowen, Pannell Kerr Forster, at 2 (July 11, 1988) (discussing mergers and acquisition services, among others).

[422] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[423] See also ISB, "Discussion Memorandum 99-4: Legal Services" (Dec. 1999).

[424] See Proposing Release, Section III.D.1(b)(ix).

[425] Codification § 602.02.e.ii.

[426] Arthur Young, 465 U.S. at 819-20 n.15.

[427] American Bar Association Commission on Multidisciplinary Practice, Report to the House of Delegates, at 5 (July 2000) ("ABA Report") (available at www.ABAnet.org/cpr/mdpfinalrep2000.html).

[428] See Ernst & Young Letter; PricewaterhouseCoopers Letter; Arthur Andersen Letter.

[429] See, e.g., Va. Sup. Ct. R. 1A:4 (2000).

[430] See, e.g., Arthur Andersen Letter.

[431] See ABA Report, supra note 427.

[432] Id. at 5 (footnote omitted).

[433] See, e.g., PricewaterhouseCoopers Letter; Deloitte & Touche Letter.

[434] AICPA Code of Professional Conduct, ET § 101.202-101.203.

[435] See, e.g., Arthur Andersen Letter.

[436] AICPA Code of Professional Conduct, ET § 102.07 ("[I]n the performance of any professional service, a member shall comply with rule 102 [ET § 102.01], which requires maintaining objectivity and integrity and prohibits subordination of judgment to others . . . . Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the services.").

[437] AICPA SAS No. 22, AU § 311.04b; AU § 9311.03.

[438] See, e.g., PricewaterhouseCoopers Letter; Deloitte & Touche Letter.

[439] AICPA Code of Professional Conduct, ET § 302.01.

[440] As Ray J. Groves, former Chairman and CEO, Ernst & Young testified, "It does not impair independence to reward a professional who excels in his or her performance, or who exceeds reasonable expectations." Written Testimony of Ray J Groves (July 26, 2000).

[441] See Letter from Lynn Turner, Chief Accountant, SEC, to Charles Bowsher, Chairman, POB (Dec. 9, 1999); see, e.g., In the Matter of PricewaterhouseCoopers, LLP, AAER No. 1098 (Jan. 14, 1999).

[442] See Letters from Lynn Turner, Chief Accountant, SEC, to Michael Conway, Chairman, SECPS Executive Committee (Nov. 30, 1998; Dec. 8, 1999; May 1, 2000).

[443] AICPA Letter; Deloitte & Touche Letter; KPMG Letter; Letter of Jodi L. McFall, CPA (Sept. 1, 2000); Letter of Electronic Data Systems (Sept. 11, 2000); Letter of William Tourville, CPA

(Sept. 14, 2000); Letter of Gary Whitsell (Sept. 19, 2000).

[444] Letter of Thomas Graves (July 18, 2000); Letter of the FEE (Sept. 25, 2000).

[445] See Ernst & Young Letter.

[446] See, e.g., Ernst & Young Letter.

[447] Proposing Release, n.192.

[448] See Ernst & Young Letter (acknowledging that the requirement applies worldwide).

[449] See KPMG Letter; Letter of KPMG Europe (Sept. 22, 2000).

[450] GAAS already requires firms to have quality controls for their audit practices and refers auditors to the "Statements on Quality Control Standards" ("SQCS") for guidance regarding the elements of those systems. AICPA SAS No. 25; AU § 161.

[451] We considered whether to use the number of firm professionals, instead of the number of SEC registrants, to determine which firms are required to implement the quality controls in Rule 2-01(d)(4) to qualify for the limited exception. See SECPS Manual § 1000.46. We use number of SEC registrants because we are particularly concerned with those firms that audit a large number of SEC registrants, regardless of the number of professionals, and because we can more easily verify the number of SEC registrants audited by a firm.

[452] Letter from Lynn Turner, Chief Accountant, SEC, to Michael Conway, Chairman, SECPS Executive Committee (Dec. 9, 1999).

[453] See, e.g., Letter of KPMG Europe (Sept. 22, 2000).

[454] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[455] See Ernst & Young Letter; PricewaterhouseCoopers Letter.

[456] Letter of KPMG Europe (Sept. 22, 2000).

[457] See Ernst & Young Letter; Letter of Ernst & Young, U.K. (Sept. 7, 2000); Letter of KPMG Europe (Sept. 22, 2000); Deloitte & Touche Letter.

[458] See Letter from Michael A. Conway, Chairman, SECPS Executive Committee, to the Managing Partners of the SECPS Member Firms (April 2000).

[459] SECPS Manual § 1000.46 (April 2000).

[460] Ernst & Young Letter (suggesting a three-year transition period); Letter of Ernst & Young U.K. (Sept. 7, 2000).

[461] AICPA Ethical Standard ET § 101.07 (grandfathering certain loans that existed as of January 1, 1992).

[462] See supra note 25.

[463] See Earnscliffe II, supra note 38, at 45, which states, "Most people sensed that the relationship between the auditor and auditee was appropriate, typically neither too close nor tension-ridden. The one area of greater concern had to do with the provision of non-audit services to audit clients, where participants felt unsettled and discomfited. Avoidance of this practice seemed preferred, but disclosure was seen as a helpful alternative step as well."

[464] The disclosure requirement pertains to the accounting firm that is the registrant's principal accountant. The principal accountant generally is the accounting firm that takes responsibility for the report on the financial statements of the registrant for each year presented. See SEC Division of Corporation Finance, "Accounting Disclosure Rules and Practices: An Overview," Topic Four, I.D. (Mar. 31, 2000).

[465] See proposed Rule 14a-101 Item 9(e)(4); Rule 10-01(d) of Regulation S-X and Item 310 of Regulation S-B, 17 C.F.R. 210.10-01, 228.310(b).

[466] Ernst & Young Letter.

[467] PricewaterhouseCoopers Letter; Ernst & Young Letter; Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000); Testimony of Philip D. Ameen, Chair, Committee on Corporate Reporting, FEI-CRR (Sept. 20, 2000).

[468] See supra Section IV.D.4.b(ii). The services described in Rule 2-01(c)(4)(ii)(B) relate to systems that aggregate source data underlying, or generate information significant to, the financial statements, which may be a particular concern to investors. See Earnscliffe I, supra note 65, at 24, which states, "Some felt that installing computer systems was not a problem . . . others argued that if the computer system had anything to do with the financial reporting systems . . . then the auditor would be in serious conflict." The required disclosure will permit investors to decide whether such services create independence concerns.

[469] See Earnscliffe I, supra note 65, at 26, which describes responses to a scenario when the annual audit fee was $1 million and the auditor performed computer system work for $10 million, which was 1% of the auditor's annual revenues, and states, "First off, the sheer size of the contract was seen as a potential perception challenge. Even though $10 million might be good value for the client, and only a tiny fraction of the audit firm's business, there was a sense of doubt that the firm would be willing to walk away from such a relationship, if that were necessary to protect the independence of the audit."

[470] Companies Act 1985, Part XI, Chapter V, Auditors, § 390B, "Remuneration of Auditors and Their Associates for Non-audit Work," and Regulations 1991, § 5, "Disclosure of Remuneration for Non-Audit Work." See generally Written Testimony of Graham Ward, Institute of Chartered Accountants of England and Wales ("ICAEW") (Sept. 13, 2000).

[471] Michael Firth, "The Provision of Nonaudit Services by Accounting Firms to their Audit Clients," Contemporary Accounting Research, at 6 (Summer 1997). Firth hypothesized that companies with potentially high agency costs (i.e., companies in which directors do not control management or which have a large amount of debt) would limit the non-audit services provided by their auditors because the appearance of a lack of auditor independence would increase their cost of capital. Firth's sample data came from the 500 largest British industrial, listed companies. Firth's findings were consistent with his hypothesis.

[472] See Arthur Andersen Letter.

[473] See Department of Trade and Industry, "A Framework of Independent Regulation for the Accounting Profession," ¶¶ 29, 35, 39, 44, and 46 (Nov. 1998).

[474] Testimony of Graham Ward, ICAEW (Sept. 13, 2000).

[475] ICI Letter.

[476] We note that audit committees currently receive information about the auditor's provision of non-audit services under ISB Standard No. 1 and SECPS Manual § 1000.08. See ISB Standard No. 1, supra note 167; SECPS Manual § 1000.08 (requiring the auditor to report annually to the audit committee or board of directors (or its equivalent in a partnership) of SEC registered audit clients on the "total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered").

[477] The O'Malley Panel has recommended that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee regarding auditors' services. The Panel set forth factors for audit committees to consider in determining the appropriateness of a service. See O'Malley Panel Report, supra note 20, at ¶ 5.30.

[478] The ISB cites threats to independence arising from these structures and identifies quality controls to ensure the independence of the auditors in these situations. See ISB, "Discussion Memorandum 99-2: Evolving Forms of Firm Structure and Organization," at 20 (Oct. 1999).

[479] AICPA SAS No. 1, AU § 543 also sets forth guidance on when a principal auditor discloses and makes reference to another auditor who performs an audit of a component of the entity.

[480] See, e.g., Testimony of Robert E. Denham, Member, ISB (July 26, 2000) (recommending that disclosure be put in footnotes to the financial statements or in the Form 10-K).

[481] See, e.g., Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investments, TIAA-CREF (Sept. 21, 2000).

[482] See Item 9 of Schedule 14A. 17 CFR 240.14a-101.

[483] 15 U.S.C. § 78(d).

[484] "Foreign private issuer" is defined in Securities Act Rule 405 (17 CFR 230.405) and Exchange Act Rule 3b-4 (17 CFR 240.3b-4).

[485] See, e.g., KPMG Letter; Arthur Andersen Letter.

[486] See Written Testimony of Wayne Kolins, National Director of Assurance, BDO Seidman, LLP (Sept. 20, 2000).

[487] See, e.g., Letter of Fred M. Rock, CPA (Sept. 20, 2000); Letter of Centerprise Advisors, Inc. (Sept. 25, 2000).

[488] See, e.g., Deloitte & Touche Letter; Testimony of Wayne A. Kolins, BDO Seidman, LLP

(Sept. 20, 2000).

[489] See Letter of Edmund Coulson, Chief Accountant, SEC, to Robert Mednick, Arthur Andersen (June 20, 1990).

[490] Questions of attribution in this context have not been analyzed on the basis of "affiliation" in the past. Indeed, the term "affiliate of the accounting firm" is not used in our current Rule 2-01 or in the Codification. The term was used in our proposed rule, along with the proposed definition of the term, to attempt to bring certainty to this issue. Since "affiliate" is defined in Rule 1-02 of Regulation S-X and we are eliminating the definition of "affiliate of the accounting firm," we have used the term "associated" instead of "affiliated" in our final rules to make clear that, consistent with the status quo, the entities treated as if they were the accounting firm will not be determined by reference to the definition of "affiliate" in Rule 1-02 of Regulation S-X. While the "control" relationships of Rule 1-02 may be adequate to warrant treating an entity as the accounting firm for independence purposes, Rule 1-02 does not set forth the exclusive circumstances in which an entity's interests will be imputed to the accounting firm in this context. In addition, we do not intend for the definition of "associated" used in any other context in the federal securities laws to apply to this term.

[491] See, e.g., Letter of Edmund Coulson, Chief Accountant, SEC, to Robert Mednick, Arthur Andersen (June 20, 1990); Letter of W. Scott Bayless, Assistant Chief Accountant, SEC, to Larry Edgerton, Elms, Faris & Co. (June 7, 1996); Letter of Lynn E. Turner, Chief Accountant, SEC, to Jeff Yabuki, American Express Financial Advisors (Nov. 2, 1998); Letter of Lynn E. Turner, Chief Accountant, SEC to Michael Gleespen, Century Business Services (Nov. 2, 1998); Letter of Lynn E. Turner, Chief Accountant, SEC, to Terry Putney, H&R Block Business Services (Nov. 2, 1998); Letter of Lynn E. Turner, Chief Accountant, SEC, to Michael Conway, KPMG Peat Marwick LLP (Jan. 7, 1999); Letter of Lynn E. Turner, Chief Accountant, SEC, to Nigel Buchanan, PricewaterhouseCoopers (July 26, 1999); Letter of Lynn E. Turner, Chief Accountant, SEC, to Kathryn A. Oberly, Esq., Ernst & Young (May 25, 2000); Letter of Lynn E. Turner, Chief Accountant, SEC, to Antonio Rosati, Director of Issuers Division, Commissione Nazionale per le Societa e la Borsa (August 24, 2000); Letter of Lynn E. Turner, Chief Accountant, SEC, to J. Terry Strange, KPMG (October 16, 2000); see also Codification § 602.02.b.ii, Ex. 8; 602.02.b.iv; 602.02.c.iii; 602.02.g, Ex. 5. Cf. SECPS Manual § 1000.45 (discussing application of SECPS rules to "foreign associated firm[s]"); AICPA Code of Professional Conduct, ET § 101.16 (Interpretation 101-14) (application of independence rules to alternative practice structures); AICPA Code of Professional Conduct, ET § 505.03 (application of independence rules to entities controlled by an accounting firm or its members). In addition, accounting firms entering into business transactions in which they acquire equity stakes in other companies will need to continue to consider whether they will have a direct or material indirect business relationship with, or a direct financial interest or material indirect financial interest in, any of their audit clients that are also clients of or enter into business relationships with or invest in or are invested in by that other company. See Letter of Lynn E. Turner, Chief Accountant, SEC, to Kathryn A. Oberly, Esq., Ernst & Young (May 25, 2000); Letter of Lynn E. Turner, Chief Accountant, SEC, to J. Terry Strange, KPMG (October 16, 2000).

[492] See AICPA Letter; Arthur Andersen Letter.

[493] See Deloitte & Touche Letter.

[494] See Codification § 602.02.b.iii (Ex. 1); 602.02.b.iv; 602.02.c.iii; 602.02.h (Ex. 9).

[495] See APB No. 18.

[496] See Letter of Stanley Keller, Esq., and Richard Rowe, Esq., ABA Committees on Federal Regulation of Securities Law and Accounting (Sept. 27, 2000).

[497] See APB No. 18, at ¶ 17. Paragraph 17 of APB No. 18 also discusses a number of considerations that may affect the ability of an entity to have significant influence over an investee.

[498] We have, however, narrowed the definition of "investment company complex" from the definition used in ISB Standard No. 2. See infra Section IV.H.11.

[499] See Arthur Andersen Letter.

[500] Rule 2-01(f)(5)(ii)(A).

[501] Rule 2-01(f)(5)(ii)(B).

[502] See, e.g., Deloitte & Touche Letter.

[503] See, e.g., Deloitte & Touche Letter.

[504] SECPS Manual § 1000.08; cf. AICPA Code of Professional Conduct, ET § 101.02.

[505] See, e.g., Ernst & Young Letter ("We also would revise the definition of `audit and professional engagement period' in the Release . . . to codify the Commission staff's practice of only requiring the latest audited period in initial filings by foreign private issuers to be fully compliant with SEC independence rules.").

[506] Arthur Young, 465 U.S. at 818.

[507] See, e.g., PricewaterhouseCoopers Letter.

[508] See, e.g., Deloitte & Touche Letter.

[509] See Deloitte & Touche Letter.

[510] AICPA SAS No. 22, AU § 311.046 and AUI 9311.03.

[511] See, e.g., Deloitte & Touche Letter; Ernst & Young Letter.

[512] See, e.g., Deloitte & Touche Letter; Ernst & Young Letter.

[513] For a discussion of the definition of "office," see infra Section IV.H.12.

[514] See Deloitte & Touche Letter.

[515] For example, leased accounting personnel might consult with a professional employee participating in an audit and thereby become a member of the audit engagement team.

[516] See Written Testimony of Ronald Nielsen and Kathleen Chapman, Iowa Accountancy

Examining Board (Sept. 20, 2000).

[517] ISB Standard No. 2, supra note 226.

[518] See, e.g., Deloitte & Touche Letter; AICPA Letter.

[519] See, e.g., Arthur Andersen Letter.

[520] See, e.g., Deloitte & Touche Letter; AICPA Letter.

[521] See AICPA Letter.

[522] The ISB Exposure Draft, cited in the AICPA Letter, states the following:

the identification of the relevant `office' or practice unit is based on the facts and circumstances, including the firm's operating structure, and requires judgment. In a traditional geographic practice office (one city location with one managing partner in charge of all operations - audit, tax, and consulting), that location should be considered to be the office. In addition, if there are smaller, nearby `satellite' offices managed under the primary city office, broadly sharing staff, etc., those locations should also be considered part of the primary office. On the other hand, many firms are now structured more on an industry specialization or line-of-service basis, and manage offices on that basis. For example, if a financial services group were a separate practice unit, and were operated that way with limited contact with personnel of other local units, that may represent a separate office for purposes of this standard. Substance should govern the office classification, and the expected regular personnel interactions and assigned reporting channels of an individual may well be more important than his or her physical location.

[523] While we discuss the costs and benefits to issuers separately from those accruing to investors, impacts on the issuers are also likely to flow to investors as owners of the issuers' securities.

[524] It has been suggested that the Proposing Release did not clearly specify the baseline from which the costs and benefits were being estimated. The following presentation clearly establishes the baseline: costs and benefits are compared to current regulations.

[525] See supra Section III.B.

[526] See Written Testimony of Jack Ciesielski, accounting analyst (Sept. 13, 2000) ("I think the real problem in attracting talent in the auditing profession is the share ownership restrictions placed on auditors. . . . The relaxation of share ownership constraints that are proposed in this document should allay most fears of future auditors.").

[527] See Rule 2-01(e)(1)(ii).

[528] The rules we adopt today are slightly more restrictive than current rules with respect to certain financial interests - such as credit cards and bank accounts - and employment relationships as they relate to covered persons on the audit engagement team. We do not anticipate that these changes will impose significant costs.

[529] Other public accounting firms would have the flexibility to adopt a system to comply with the requirement in light of the nature and size of their practice. See SAS No. 25, AU § 161.03. This

is in general conformity with GAAS, which states, "The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations." See SAS No. 25, AU § 161.02.

[530] Because the threshold for the limited exception is based on the number of audit clients rather than professionals, certain middle-tier firms, if they grow, may meet the threshold earlier than they would under current SECPS requirements. See SECPS Manual § 1000.46. We note that our rule does not require implementation of these systems, but rather leaves it to the discretion of the firm.

[531] SAS No. 25, AU § 161 n.1.

[532] AICPA Professional Standards: SQCS, QC § 20.09.

[533] See "International Accounting Standards," Securities Act Rel. No. 7801 (Feb. 16, 2000) [65 FR 8,896]; Form 20-F, Item 8, "Financial Information," 17 CFR 249.220f.

[534] See SECPS Manual § 1000.45.

[535] See Letter from Michael A. Conway, Chairman, Executive Committee, SECPS, to the Managing Partners of SECPS Member Firms, April 2000 (available at www.aicpa.org).

[536] See Romac International, 1999 Salary Survey and Career Navigator: Finance & Accounting (1999), which reports the median national public accounting salary to be $47,300 annually. Assuming a 2080-hour work year, we obtain $22.75 per hour. We increase our hourly estimate to $30 to allow for benefits and other overhead expenses.

[537] See supra Sections IV.D.1, IV.D.2.

[538] See supra Section III.B.

[539] In the Proposing Release, the proscribed services included expert witness services. Expert witness services have been removed from the list of services that are per se incompatible with an auditor's independence.

[540] Under the final rule, the term "internal audit services" does not include operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements. Additional discussion of the impact of this threshold appears in Section IV.D.4.b(v).

[541] Throughout this section we round percentages to one decimal place. As a result some percentage combinations, when relevant, will not add to exactly 100.

[542] Our purpose in using these data is to estimate the association between company size and the auditors classified as Big Five, second tier and smaller accounting firms. The Compustat Database has two limitations for purposes of this estimate. First, the Compustat Database does not include all companies filing with the SEC. Second, we note that Compustat includes American Depository Receipts (ADRs). Some of the companies issuing ADRs and included on Compustat may not be required to file audited financial statements with the SEC. The data include 499 non-bank filers who issue ADRs; 405 are for companies with $200 million or more

of assets; and 94 are companies with less than $200 million in assets. Only 57 of these ADR issuers are not audited by Big Five accounting firms.

The data also include 22 bank holding companies with $200 million or more of assets that have issued ADRs. The database contains information on approximately 9,414 registered companies including bank holding companies. Compustat applies set criteria for adding companies to the database. The criteria vary depending upon whether a company is domiciled in the U.S., Canada or abroad. The net effect of these criteria is that Compustat is heavily weighted toward larger companies, particularly, larger North American companies. If these criteria have the effect of excluding smaller companies that may have assets of less than $200 million, this analysis will overstate the proportion of companies that will be affected by the rule and the impact of the rule on smaller companies. See Compustat Database, October 31, 2000.

[543] The average revenue of companies with assets of $195 - $205 million is $209 million.

[544] See Testimony of Paul Volcker, former Chairman, Board of Governors of the Federal Reserve System (Sept. 13, 2000) ("I know that when . . . I was Chairman, there was still a question of whether banks had to be audited, and they are, of course, examined and many of the banks complain that it would be very costly and they didn't have the resources for decent internal auditing efforts. . . ."); see also Testimony of Laurence H. Meyer, Governor, Board of Governors of the Federal Reserve System (Sept. 13, 2000); Testimony of John D. Hawke, Jr., Comptroller of the Currency (July 26, 2000). Both indicated that their respective organizations have been concerned about internal audit outsourcing for some time. Neither organization has placed an absolute ban on internal audit outsourcing. However, both have provided guidance on the manner in which internal audit outsourcing is to be handled.

[545] Professional staff of the Office of the Chief Accountant obtained the names of bank holding company auditors by searching Commission 10-K filings contained in EDGAR. 10KWizard was utilized to search the EDGAR database.

[546] Only ten of the 91 bank companies with less than $200 million in assets were located in one of the top 35 U.S. cities by population. See Compustat Database, October 31, 2000.

[547] The Institute of Internal Auditors ("IIA") Global Auditing Information Network ("GAIN") cited by Larry E. Rittenberg and Mark A. Covaleski in their monograph, The Outsourcing Dilemma: What's Best for Internal Auditing for IIA (1997) ("Rittenberg") and Manufacturers Alliance, Survey of General Audit (2000) generally include large companies. According to Rittenberg, companies included in the IIA GAIN study are large, increasing the probability that the GAIN companies are Big Five clients. Only two of the companies responding to the Manufacturers Alliance survey used accounting firms other than a Big Five firm as the primary external auditor. The Alliance survey reported a ten percentage point increase in the outsourcing of general audit tasks to the primary external auditor between 1995 and 2000. Of the companies using Big Five firms as their primary auditor, 42.5% indicated that they outsourced general audit work to their primary auditor. The survey also indicates that the portion of general audit needs that is outsourced remains fairly small, at less than 5% for 72.9% of the respondents.

[548] As noted above, our definition of internal audit is narrower than that used by Rittenberg and Covaleski.

[549] Rittenberg and Covaleski provide data that allows us to estimate the potential impact of the 40% limitation included in the rule. The Table below uses the information above to estimate the internal audit outsourcing and extended audit services that the external auditor can perform for the SEC registrant audit clients after the new rule is in effect. According to the IIA GAIN information in 1995 studied by Rittenberg and Covaleski, 35% of internal audit activities were classified as "operational." These activities can be fully outsourced under the rule. The remaining services were classified as follows: 17% compliance audit; 14% information systems; 26% financial audits; 8% other (unspecified). The rule will allow 40% of these services to be outsourced. Accordingly, under the rule, 61% of internal audit services could be outsourced.

In addition, the Manufacturers Alliance conducted its Survey of General Audit, 2000 and received responses from 106 companies of which 104 were audited by Big Five firms. It asked respondents how general audit time was allocated and received the following response: 40.2% control/compliance, 32.3% operational audit, 5.9% assisting external audit, 11.0% service requests, 3.4% M&A work and 7.1% other activities. While the categories are generally not the same as those used in the IIA GAIN reports, the operational audit component in both surveys is similar. On the other hand, control/compliance work is much higher for the Alliance survey respondents than the apparently similar category used in GAIN. This might be attributed to classification problems and/or the time period considered. However, in 1995 the Alliance survey reported an even higher control/compliance allocation at 46.9%. Further, the Alliance survey does not break out IT work specifically, making it difficult to compare the two survey results on this dimension. Alliance survey respondents did indicate that computer systems oriented work was growing rapidly (33%) or somewhat rapidly (59.4%). The Alliance survey reported a rise from 20.0% in 1995 to 32.3% in 2000 in the operational audit category, a category of internal auditing services not prohibited by the rule.

[550] See Letters from Commissioner Isaac C. Hunt, Jr., supra, note 212. Some commenters suggested that by requesting data on the costs and benefits of the rule, we asked the public to shoulder a burden rightfully belonging to the regulator. See, e.g., Arthur Andersen Letter. We do not suggest that any party was obligated to provide data in response to our requests for comments. On the other hand, where data are exclusively under the control of commenters, our rules cannot be criticized for any failure to take into account data to which we do not have access. Wherever possible, we relied on information supplied by interested parties and other public sources of information.

[551] See Letter of Kim Johnson, General Counsel, The Public Employees Retirement Association of Colorado (September 1, 2000); Testimony of Allen Cleveland, New Hampshire Retirement System (Sept. 13, 2000); Testimony of John Biggs, Chairman, President and CEO of TIAA-CREF (July 26, 2000).

[552] See Testimony of Kayla Gillan, General Counsel, CalPERS (Sept. 13, 2000).

[553] See Testimony of Jay Eisenhofer, Partner, Grant & Eisenhofer (Sept. 13, 2000) ("Your rule, I believe, will cut down on fraud, cut down on auditor self-interest, and increase the reliability of financial statements.").

[554] See, e.g., KPMG Letter.

[555] See, e.g., Arthur Andersen Letter.

[556] See, e.g., Deloitte & Touche Letter.

[557] See, e.g., Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("It is important to note that audit firms do not provide consulting services to improve the quality of the audits, but rather for commercial considerations. A then CEO of one of the Big Five audit firms was quoted recently in Business Week saying `If I had to trade an auditing account for other business, I would do it.'").

[558] Despite the mixed academic results and the difficulties in preparing unbiased survey results, it is clear that the perception of auditor independence is important to financial statement users and can be affected negatively by the extent and type of non-audit services provided by the auditor to audit clients.

Perception is difficult to establish definitively. A number of academics have provided evidence that perceptions are affected by the mix of audit and non-audit services provided to audit clients. The academic evidence is mixed and subject to alternative interpretation. Selected papers by academics include: M. Firth, "Perceptions of Auditor Independence and Official Ethical Guidelines," 55 Acct. Rev., at 451-466 (July 1980) ("Firth"); R.A. Shockley, "Perceptions of Auditors' Independence: An Empirical Analysis," 56 Acct. Rev., at 785-800 (October 1981) ("Shockley"); D.J. Lowe and K. Pany, "CPA Performance of Consulting Engagements with Audit Clients: Effects on Financial Statement Users' Perception and Decisions,"14 Auditing: J. of Prac. & Theory, at 35-53 (Fall 1995) ("Lowe 1995"); D.J. Lowe and K. Pany, "An Examination of the Effects of Type of Engagement Materiality, and Structure on CPA Consulting Engagements with Audit Clients," 10 Acct. Horizons, at 32-52 (December 1996) ("Lowe 1996"); J.G. Jenkins and K. Krawczyk, "Perception of the Relationship Between Nonaudit Services and Auditor Independence," North Carolina State University, manuscript (2000) ("Jenkins & Krawczyk").

Generally, Firth and Shockley found that financial statement users are more concerned than auditors about the independence problems associated with matters such as incentives to retain clients in a competitive environment and/or when non-audit services are sold to audit clients. More recently, Lowe (1995, 1996) found that loan officers and financial analysts appear to perceive little or no independence problem at low levels (1% of office revenue) of non-audit services, but did exhibit concern as the level of office revenues from non-audit services rose. Jenkins & Krawczyk studied three group's perceptions about auditor independence and the provision of non-audit services to audit clients. The Jenkins and Krawczyk study groups are Big Five CPA professionals, non-Big Five CPA professionals and a group labeled "general public," composed of business professionals and graduate business students. The CPA professionals, particularly those associated with the Big Five, generally felt that independence was not threatened and in some cases might be strengthened by the provision of non-audit services to audit clients. The "general public" was generally supportive of the provision of non-audit services, but less so than the other two groups.

Recent surveys of a variety of financial statement users demonstrate the existence of varying degrees of concern for auditor independence when offering non-audit services to audit clients. The story told by the surveys is admittedly complex. Virtually all of the surveys that have been submitted to the public record (Public Opinion Strategies, Brand Finance PLC, Earnscliffe, AIMR, Penn Schoen Survey, and Pace University) indicate some concern for auditor independence. The degree of concern may be, in part, a function of the timing of the surveys, the manner in which the subjects were queried, and the subject sample selection.

[559] Duquesne Poll, supra note 110. The surveyors asked several related questions of the subjects. First they asked, "And from what you've seen, read or heard, do you generally favor or oppose this SEC proposal?" This was immediately followed by, "And do you strongly favor/oppose or just somewhat favor/oppose the SEC proposal." In response to this question, 30% stated that they "Strongly Favor" and 34% that they "Somewhat Favor" the SEC proposal. The surveyors then provided a one paragraph narrative describing the auditor's responsibilities with respect to fair presentation of financial statements and a one paragraph narrative describing the SEC concerns about the potential conflict of interest auditors face when selling both audit and consulting services to the same client. The subjects were then asked to state whether they strongly/somewhat favor/oppose a position based on this information. At this point 49% stated that they "Strongly Favor" and 32% stated that they "Somewhat Favor" the SEC proposal.

[560] See Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000).

[561] See Letter of Brand Finance PLC (June 13, 2000).

[562] See Testimony of Rajib Doogar (Sept. 13, 2000) ("Low audit credibility, in turn, will drive up costs of capital, affecting the well functioning of capital markets and indeed of the US economy as a whole.").

[563] See Letter of Charles C. Cox, Kenneth R. Cone, and Gustavo E. Bamberger, Lexecon Inc. (Sept. 25, 2000) ("Lexecon Letter").

[564] See, e.g., M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," 3 J. of Fin. Econ, at 305-360 (1976); A.A. Alchian and H. Demsetz, "Production, Information Costs, and Economic Organization," 62 Am. Econ. Rev., at 777-795 (1972). This agency conflict grows out of the inability of investors to perfectly control by contract managers' behavior. The problem is exacerbated if investors cannot monitor management's choices.

[565] See M. H. Bazerman, K.P Morgan, and G.F. Loewenstein, "The Impossibility of Auditor Independence," 38 Sloan Mgt. Rev. 89-94 (Summer 1997); Testimony of Professor Max H. Bazerman, Northwestern University (July 26, 2000); Testimony of Professor George F. Loewenstein, Carnegie Mellon Institute (July 26, 2000); J.D. Beeler and J.E.Hunton, "Contingent Economic Rents: Insidious Threats to Auditor Independence," manuscript (2000); G. Trompeter, "The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Audit Partner Judgment," 13 Auditing: J. Prac. & Theory, at 56-68 (Fall 1994). Trompeter provides experimental evidence that compensation schemes can influence subject judgments. Trompeter finds that auditors whose rewards are based on local office revenues have a tendency to support management views more often than if their rewards are computed on the broader firm revenue base. In the latter case, loss of a local client does not necessarily lead to substantial individual reward losses. Trompeter addresses the incentives issue, one of the complex issues possibly leading to subtle biases in judgment. His results suggest a self-serving bias effects judgment. But see Testimony of Professor Urton Anderson, University of Texas (Sept. 21, 2000) and Professor Don N. Kleinmuntz, University of Illinois at Urbana-Champaign (Sept. 21, 2000) for arguments that the self-serving bias is overcome in practice by a

variety of behavioral and institutional factors. See R.R. King, "An Experimental Investigation of Self-Serving Biases in an Auditing Trust Game," manuscript (2000).

[566] See AICPA Practice Aid Series, Make Audits Pay: Leveraging the Audit into Consulting Services (1999). Furthermore, as a result of the rule, issuers may avoid marketing pressure from their auditors to purchase certain non-audit services.

[567] See Testimony of John C. Whitehead, retired Chairman, Goldman Sachs & Co. (Sept. 13, 2000).

[568] See Testimony of D. Bevis Longstreth, former SEC Commissioner and Member of the O'Malley Panel (Sept. 13, 2000).

[569] See, e.g., Lexecon Letter.

[570] See, e.g., Deloitte & Touche Letter.

[571] See, e.g., KPMG Letter. See supra Section III.C.4, for a discussion of this comment. But see Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("I agree with the Commission that the absence of `proof' does not justify inaction, particularly when such evidence cannot be expected to be demonstrable.").

[572] See, e.g., Testimony of Richard Blumenthal, Attorney General, State of Connecticut (Sept. 20, 2000); Testimony of Robert Morgenthau, District Attorney for the County of New York (Sept. 13, 2000); Testimony of Charles R. Drott (Sept. 13, 2000).

[573] See, e.g., Lexecon Letter.

[574] See, e.g., Lexecon Letter. The authors cite two studies that find accounting firms face significant costs when government regulators criticize auditors: M. Firth, "Auditor Reputation: The Impact of Critical Reports Issued by Government Inspectors," 21 Rand J. of Econ., at 374-387 (Autumn 1990) and L. R. Davis and D. T. Simon, "The Impact of SEC Disciplinary Actions on Audit Fees," 11 Auditing: J. of Prac. & Theory, at 58-68 (Spring 1992). In the former study, the loss of reputation in the U.K. manifested itself in lower market share for the largest accounting firms, while in the latter loss of reputation was related to a reduction in audit fees. We note that in both studies governmental oversight was responsible for making public the improper auditor behavior. It is not clear from this research that other economic forces were (or are) sufficiently strong to impose the costs to loss of reputation.

[575] See, e.g., Lexecon Letter.

[576] See Lexecon Letter for a discussion and bibliography on this point.

[577] See SECPS Manual §1000.45 (April 2000).

[578] See, e.g., Testimony of Dennis Paul Spackman, Chairman, National Association of State Boards of Accountancy (Sept. 13, 2000); Testimony of Paul Volcker, former Chairman, Board of Governors of the Federal Reserve System (Sept. 13, 2000).

[579] See Testimony of Rajib Doogar (Sept. 13, 2000).

[580] See, e.g., Lexecon Letter.

[581] See Testimony of Professor John C. Coffee, Jr., Columbia University (July 26, 2000).

[582] This effect can be observed in a simple present value calculation. Assuming future cash flows of $100 per period and a discount rate or required rate of return of 10%, the present value of the cash flows in perpetuity is $1,000. If the discount rate is reduced to 9%, a 10% change in the discount rate, the present value of the future cash flows is $1,111, an 11% change in the present value. This analysis ignores the possibility that a decrease in the discount rate can change the investment opportunity set and increase the per-period cash flows.

[583] While we recognize that the set of firms that may purchase such services may change from year to year, we have received no evidence to suggest that the fraction of companies that may actually purchase such services in any given year is different from our estimate.

[584] See GAO Report. Appendix B of the Proposing Release, Table 4 provides a 1999 comparable figure of 76.68%.

[585] See Compustat Database (October 31, 2000).

[586] This calculation is based on the aggregate value of U.S. equities markets of $16.1 trillion as of September 29, 2000 as reported by Wilshire Associates and an additional $4.3 trillion in corporate debt outstanding issued by U.S. firms as of June 30, 2000 as reported by the Board of Governors of the Federal Reserve. Therefore the aggregate value of outstanding debt and equity securities is $20.4 trillion.

[587] See "Accounting Wars," Bus. Wk., at 156-168 (Sept. 25, 2000).

[588] See Testimony of Bill Patterson, Director, Office of Investments, AFL-CIO (Sept. 20, 2000) ("Now, the individual investor, I think their interest in the process is really catalyzed again around these high profile irregularities like Cendant, Sunbeam, Lucent, and Waste Management. I think these are warning shots to investors that this is a problem that has to be addressed.").

[589] See Testimony of Frank Torres, Consumers Union (Sept. 20, 2000) ("I think American consumers, from my experience, don't like the idea that they might get had.").

[590] See, e.g., Letter of Jack Ciesielski, accounting analyst (July 14, 2000); Letter of William V. Allen, Jr. (Aug. 22, 2000); Testimony of John Biggs, Chairman and CEO of TIAA-CREF (July 26, 2000); Testimony of Kayla J. Gillan, General Counsel, CalPERS (Sept. 13, 2000) ("A clear, simple and bright line [prohibition] standard will avoid this tendency [toward creative ways to avoid the rule], and moreover, I have not heard anyone suggest that there is an absence of qualified and cost effective alternatives to the auditor performing nonaudit consulting services to the same client.").

[591] See, e.g., Lexecon Letter.

[592] Some commenters suggested that the rule would impose additional costs on small businesses and accounting firms. The impact of the rule on small entities is discussed below in Section VI.

[593] See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter.

[594] See Manufacturers Alliance, Survey of General Audits (2000). In a survey of its members, the Alliance found that just less than 96% of respondents outsourced less than 35% of the internal audit. This amount is within the 40% threshold allowed by the rule.

[595] Memorandum to File No. S7-13-00 (September 23, 2000).

[596] See Testimony of William D. Travis, Managing Partner, McGladrey and Pullen, LLP (Sept. 20, 2000). According to Mr. Travis' testimony, 85% of McGladrey and Pullen LLP's total revenues are attributable to accounting, auditing and tax. Therefore, only 15% is attributable to all consulting engagements. In addition the testimony indicates that approximately 50% of the firm's accounting and tax clients purchase audit services and that only 15% of its client base is made up of public companies. Mr. Travis also notes elsewhere in his testimony that "[t]he IT practice [] was part of what was sold to an affiliate of Block, so the consulting practice is owned entirely by Block." See also Compustat Database, October 31, 2000. Compustat lists only five companies with assets of $200 million or more as audited by McGladrey and Pullen, LLP.

[597] Two studies in the 1980s documented that audit fees were generally greater, after controlling for other factors, for clients that also purchased non-audit services from the same public accounting firm. See Z. V. Palmrose, "The effect of non-audit services on the pricing of audit services," 24 J. of Acct. Res., at 405-11 (Autumn 1986); D. A. Simunic, "Auditing, consulting, and auditor independence," 22 J. of Acct. Res., at 679-702 (Autumn 1984). Palmrose found that the positive relationship held for both incumbent and non-incumbent auditors, suggesting that synergies may not exist. Nevertheless, the authors of these studies concluded that this evidence was not inconsistent with the hypothesis that the joint provision of audit and non-audit services may give rise to "knowledge spillovers." More recent research documents that these higher fees are associated with increased audit effort (in labor hours). See L. R. Davis, David N. Ricchiute, and G. Trompeter, "Audit Effort, Audit Fees, and the Provision of Non-audit Services to Audit Clients," 68 Acct. Rev., at 135-50 (Jan. 1993). The results of the Davis study therefore cast further doubt on the knowledge spillover hypothesis.

Three recent studies also address the issue of synergies at least indirectly. See B. Arrunada, "The Provision of Non-Audit Services by Auditors: Let the Market Evolve and Decide," 19 Intl. Rev. of Law and Econ., at 513-31 (1999) ("Arrunada"); M. Ezzamel, D.R. Gwilliam and K.M. Holland, "Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship Between the Pricing of Audit and Non-audit Services," 27 Acct. and Bus. Res., at 3-16 (1996) ("Ezzamel"); K. Pany and P. M. J. Reckers, "Auditor Performance of MAS: A Study of its Effects on Decisions and Perceptions," Acct. Horizons, at 31-38 (June 1988) ("Pany & Reckers"). Ezzamel in the U.K. observed a positive relationship between audit fees and non-audit fees. But the authors do not distinguish between competing explanations of the observed phenomenon. Pany & Reckers conducted an experimental study on U.S. loan officers. They did not find deterioration in the loan approval rate as consulting fees increased. But they did find limited evidence that providing MAS at a level of 90% of audit fees for a period of three years may present an independence perception problem among some financial analysts. They note that in 1988, levels of MAS fees as high as 90% of audit fees were uncommon. Arrunada states that after examining the effects of the provision of non-audit services on service cost, audit competition, service quality, and auditor independence, "[he] concludes that the provision of non-audit services reduces total costs, increases technical competence, and motivates more intense competition. Furthermore, it does not necessarily damage either auditor independence or the quality of non-audit services."

[598] See Testimony of Philip A. Laskawy, Chairman, Ernst & Young LLP (Sept. 20, 2000). Mr. Laskawy commented on this matter as it relates to information systems consulting:

We recently sold our practice in this area. We did so for a variety of reasons, but one reason certainly was that although we did not believe independence was actually impaired by this service, we could understand that particularly with large fees that sometimes are involved an appearance problem could be present. I might note that now that we have sold this practice we have not discovered that we are somehow enfeebled, unable to perform effective audits or to maintain top-notch audit and tax practices. In fact, we have found more the opposite to be true. Without a large consulting practice to manage we are now more targeted and more focused on our core audit and tax business, and our audit and tax partners feel as though they, and not the management consultants, are in the drivers seat at the firm. Moreover, from our clients' perspective, there actually may be an advantage in not having such a practice. We have had a greater string of wins in obtaining new audit clients since we sold our management consulting practice than we had at any time in recent history, four new Fortune 500 clients, including two Fortune 50 companies, just within the last six months.

See also Testimony of James J. Schiro, Chief Executive Officer, PricewaterhouseCoopers, before the Panel on Audit Effectiveness (July 10, 2000) ("[Our] restructuring will allow us to rededicate ourselves to our core principles."); Testimony of J. Terry Strange, Global Managing Partner, Audit, KPMG LLP, (July 26, 2000) ("In our view, the restructurings that are underway are driven by market forces, not regulatory considerations."); Testimony of Thomas Goodkind, CPA (Sept. 13, 2000) (responding to a question about his experiences relating to synergies and knowledge transfers between audit and non-audit staff, Goodkind replied, "In my experience, a transference of knowledge, I've rarely seen that in my experience."); Testimony of Douglas R. Carmichael (July 26, 2000) ("The counter argument that consulting improves audit quality is also unproven and does not provide a basis for eliminating the proposed restrictions."); Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("It is important to note that audit firms do not provide consulting services to improve the quality of the audits, but rather for commercial considerations.").

[599] See Public Accounting Report: Annual Survey of National Accounting Firms (2000) ("PAR").

[600] See Manufacturers Alliance, Survey of General Audit (2000). We use data from table 13 and table 66 to derive this ratio.

[601] Id. at table 16.

[602] Id. at table 73.

[603] Data are derived from PAR. The average growth rate in non-audit service revenues in 1999 was 21% and 9% for auditing and accounting services. Because there is uncertainty about whether individual firms classify internal audit outsourcing as consulting or assurance services, we choose the larger growth rate. In the current economy this may represent an optimistic growth rate.

[604] See Testimony of Professor Rick Antle, Yale University (July 26, 2000) ("I'll tell you now

that as far as I know there's no systematic evidence as to the magnitude of these economies, just none that I know of."). See also Letter of Professor Rick Antle, Yale University (Sept. 25, 2000). Professor Antle provides analysis to estimate the aggregate cost of lost synergies. He estimates the value of the non-audit services as "the additional value of having the consulting done by the audit firm." He further estimates this value at $700 million, the gross margin attributable to all non-audit services provided to SEC audit clients in 1999. This number likely over-estimates the gross profits for these services in the future for two reasons: First, it includes revenues for non-audit services for the Big Five firms, two or three of which have sold or are committed to selling most of these practices. Second, the rule does not prohibit the purchase of all non-audit services by audit clients. In addition, Professor Antle estimates the aggregate social benefit of non-audit services purchased from any provider. Because the rule does not prohibit the purchase of any of these services, this estimate is not relevant to the cost-benefit analysis.

605 Professor Antle's assumption about the value of synergies to the gross profit before partner compensation implies that the value of these synergies is on the order of 4% of non-audit revenues from SEC clients.

606 See also Testimony of Charles Cox, Kenneth R. Cone and Gustavo E. Bamberger, Lexecon, Inc. (Sept. 25, 2000). These commenters also estimate the aggregate cost of lost synergies on the order of 1%-2% of non-audit revenues from SEC clients.

607 See Testimony of Stephen G. Butler, Chairman and Chief Executive Officer, KPMG (Sept. 21, 2000). In response to a Commissioner's question about the source of non-audit service revenues, Mr. Butler commented that any statement attributing a percent of non-audit services to SEC audit clients for his firm would be difficult to interpret. Butler stated that "it is difficult to look at that sort of statistic because that's not a constant 20% that buys that service from us. It might be 20% of the number of our clients this year, it might be the same percentage next year, but it might be a totally different 20 percent."; Testimony of Robert K. Elliott, Chairman, AICPA (Sept. 21, 2000) ("[auditing is] . . . not an annuity, [but] it is more like an annuity than a consulting engagement which, when it's over, it's over.").

608 We assume that these costs may represent as much as 5% of the revenues from proscribed services purchased by each affected company. If as many as 10% of the purchasers of proscribed internal audit services from their auditor have contracts in excess of eighteen months and the entire $251.3 million represents revenues from proscribed services, the aggregate transition costs would be $1.3 million. Some may argue that transition costs are substantially higher, but we note that if transition costs are sufficiently high, economic theory suggests the service providers would be, on average, charging higher fees for the same level of service to the detriment of their clients. See, e.g., T. Nilssen, "Two Kinds of Consumer Switching Costs," 23 Rand J. of Econ., at 579-589 (Winter 1992).

609 See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter.

610 See, e.g., Letter of Letter of W. Steve Albrecht, Professor and Associate Dean, Marriott School of Management, Brigham Young University (Aug. 25, 2000); Letter of Professor James Jiambalvo, University of Washington (Sept. 14, 2000); Written Testimony of Professor Peter Cappelli, Wharton School (Sept. 20, 2000).

611 See, e.g., Testimony of Joseph F. Berardino, Managing Partner, Assurance and Business

Advisory Services, Arthur Andersen (July 26, 2000); Written Testimony of Stephen G. Butler, Chairman and Chief Executive Officer, KPMG (Sept. 13, 2000).

[612] See Testimony of J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche (July 26, 2000) ("A final assertion that quality will ultimately decline because the `new audit profession' will be unattractive to the best and brightest people. I cannot evaluate that possibility but would observe that the audit-dominated firms of the future that today's leaders express concerns about are in many respects comparable to the firms that attracted them (and me) to the profession twenty or more years ago. Certainly much has changed in that time period, but I would expect the right leaders to be able to make such firms attractive once again.").

[613] See Salary Survey Fall 2000, National Association of Colleges and Employers, 2000. Recent starting salaries for accounting graduates are 23% lower than those for information systems, 24% for consulting and 9% for financial and treasury analysis; see also Testimony of Robert K. Elliot, Chairman, AICPA (Sept. 21, 2000); Testimony of Barry Melancon, President and Chief Executive Officer, AICPA (Sept. 21, 2000).

[614] See, e.g., Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) ("It is more likely that recruitment has been jeopardized by the actions of the accounting firms themselves. Some of the firms have diverted investment and resources out of the audit function and into non-audit services, thereby reducing the attractiveness of the audit function as a career path. They have created the very environment in which accounting majors look elsewhere and audit staff move over to the consulting side as quickly as they can."); see also O'Malley Panel Report, supra note 20, at ¶ 4.4 ("Focus group participants often indicated that not only clients, but also engagement partners and firm leaders, treat the audit negatively - as a commodity."). See generally the Taylor Research and Consulting Group, Inc., Final Quantitative Report (2000); Albrecht and R. Sack, Accounting Education: Charting the Course through a Perilous Future, at 23 (August 2000). AICPA statistics presented to the O'Malley Panel indicate that from 1992 to 1997 the number of students obtaining bachelor degrees declined by 14%, those obtaining finance degrees declined by 17%, those obtaining general business degrees declined by 8%, and those obtaining marketing degrees declined by 27%.

[615] See Digest of Educational Statistics, 1999.

[616] See, e.g., Written Testimony of Mauricio Kohn, CFA, CMA, CFM, AIMR (Sept. 20, 2000) (submitting survey); Letter of Mary Ellen Olivierio and Bernard Newman, Lubin School of Business, Pace University (Sept. 23, 2000).

[617] See Lexecon Letter; Letter of Brand Finance PLC (June 13, 2000).

[618] The Commission imposed a similar disclosure requirement when it issued ASR 250. As noted above, ASR 250 was withdrawn three years later. The rule prompted some academic research at the time. Three studies from the period and a current study are of particular interest: J. H. Scheiner and J.E. Kiger, "An Empirical Investigation of Auditor Involvement in Non-Audit Services," 20 J. of Acct. Res., at 482-496 (Autumn 1982) ("Scheiner & Kiger); J. H. Scheiner, "An Empirical Assessment of the Impact of SEC Nonaudit Service Disclosure Requirements on Independent Auditors and Their Clients," 22 J. of Acct. Res., at 789-797 (Autumn, 1984) ("Scheiner"); G. W. Glezen and J.A. Millar, "An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No. 250," 23 J. of Acct. Res., at 859 - 870 (Autumn

1985); M. Ezzamel, D.R. Gwilliam and K. M. Holland, "Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship Between the Pricing of Audit and Non-audit Services," 27 Acct. and Bus. Res., at 3-16 (1996) ("Ezzamel").

Scheiner and Glezen studied the impact of ASR 250 disclosure requirements on the provision of audit and non-audit services and concluded that the major accounting firms did not significantly reduce the amounts of services offered. Glezen compared stockholder approval of auditors before and after the issuance of ASR 250 and found no significant decline in the approval ratios across the three periods. These authors generally conclude that either independence is not important to stockholders, a conclusion they consider unlikely, or the level of non-audit services did not reach the level at which independence was perceived to be threatened. Scheiner allows that the firms in his study were not providing clients many of the services that fell within the disclosure rule. Scheiner and Kiger find evidence that the non-audit services provided to audit clients at that time generally "consisted of traditional accounting services -- primarily tax services. Less traditional services which are often questioned by critics of the accounting profession comprise only a small part of total non-audit services." They further state that at that time, "[t]he prohibition of non-accounting, non-audit services would not appear to have a substantial impact on firms because these services do not represent a large percentage of total revenues."

As we discussed in Section III.B., the level of non-audit services in general and non-audit services for audit clients in particular have increased substantially in recent years. Ezzamel found in the U.K. that substantial income was produced by non-audit services and that "the extent of voluntary disclosure of the breakdown on non-audit services was limited and the existing disclosure requirement allowed considerable variety in the manner in which non-audit services incurred or paid abroad were disclosed."

[619] ISB Standard No. 1, supra note 167. In addition, SAS No. 61 provides additional guidance on topics that an auditor should discuss with the audit committee (or board of directors if there is no such committee) of each registrant. AICPA SAS No. 61, AU § 380.

[620] SECPS Manual § 1000.08(i).

[621] In our Paperwork Reduction Act analysis in the Proposing Release, we estimate that approximately 9,892 respondents file proxy statements under Schedule 14A and approximately 253 respondents file information statements under Schedule 14C. We based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year.

[622] See Deloitte & Touche Letter. Deloitte & Touche provided an estimate of 3-6 hours per filing for a small firm and 50-100 hours for a large firm, but provided no data to support this estimate.

[623] The ongoing figure is not adjusted for inflation or growth in consulting revenues beyond 2000. However, we note that there is a slowdown in the growth of these services. See, e.g., PAR, End of a Run: National Firms' Growth Rate Slowed In FY 99 (Mar. 31, 2000).

We note that the transition costs of $1.3 million may be incurred at any time over the eighteen-month transition period. We include this estimate in the first year only for ease of presentation.

[624] 5 U.S.C. § 603.

[625] 17 CFR 240.14a-101.

[626] See supra note 8.

[627] See supra notes 215, 216.

[628] Letter of Jim J. Tozzi, Member, Board of Advisors, Center for Regulatory Effectiveness (Aug. 30, 2000) ("Tozzi Letter").

[629] 17 CFR 230.157.

[630] 15 U.S.C. § 77c(b).

[631] 17 CFR 270.0-10.

[632] 13 CFR 121.201.

[633] Tozzi Letter.

[634] See supra notes 218, 219.

[635] See supra note 221.

[636] See, e.g., AICPA Letter.

[637] Id.; see also Letter of David E. Pertl, Senior Vice President and CFO, First Choice, Inc. (Sept. 18, 2000); Letter of Kelly Schwarzbeck, CPA, Alexander X. Kuhn & Co. (Aug. 22, 2000); Letter of Robert L. Bunting (Aug. 22, 2000).

[638] See, e.g., Letter of the California Chamber of Commerce (Sept. 15, 2000); Letter of Joseph C. King, CPA, Faulkner & King, PSC (Sept. 13, 2000).

[639] See, e.g., Letter of Landon J. Brazier, Knight Vale & Gregory (Aug. 31, 2000); Letter of Stephen Lange Ranzini, Chairman, CEO and President, University Bank (Sept. 9, 2000).

[640] See, e.g., Letter of Dean R. Heintz, CPA, Casey Peterson & Assoc., Ltd. (Aug. 8, 2000); Letter of Patrick J. Day, CPA (Aug. 10, 2000).

[641] Letter of Patrick J. Day, CPA (Aug. 10, 2000).

[642] See Testimony of Larry Gelfond, CPA, CVA, CFE, former President of the Colorado State Board of Accountancy (Sept. 13, 2000); Letter of John Mitchell, CPA (Aug. 14, 2000).

[643] See Public Accounting Report, Special Supplement: Annual Survey of National Accounting Firms - 2000 (March 31, 2000); Annual Reports to SECPS, Annual reports filed with AICPA Division for CPA firms; SECPS Reports, Reports prepared by the AICPA Division for CPA firms.

[644] See Compustat Database, Oct. 31, 2000. The 85% figure excludes clients that are bank holding companies. For further analysis, see the cost-benefit analysis in Section V.B above.

[645] See supra note 476.

[646] See supra Section IV.G.

[647] See, e.g., Letter of Donald G. Mantyla, CPA (Sept. 25, 2000).

[648] Letter of Stanley Keller, Chair, Committee on Federal Regulation of Securities, American Bar Association (Sept. 27, 2000); Letter of Robert Bunting (Sept. 6, 2000); Letter of P. Gerard Sokoloski, CPA, President, NY State Society of Certified Public Accountants (Sept. 25, 2000).

[649] 44 U.S.C. 3501 et seq.

[650] One commenter raised a number of issues related to OMB's processing and review of our submission. Because OMB has reviewed and approved our submission, we do not address these comments here.

[651] See, e.g., Letter of Center for Regulatory Effectiveness: CRE Report Card on the SEC's Proposed Rule on Auditor Independence ("CRE Report Card").

[652] See, e.g., Letter of Douglas R. Cox, Gibson, Dunn and Crutcher (Aug. 22, 2000) ("Cox Letter"). This commenter suggested, among other things, that the rule mandates disclosure of information that would appear irrelevant to the selection of auditors because a vote to ratify auditors is not required by the federal securities laws or many state laws. The commenter noted that the rule requires disclosure on Schedule 14C which does not ask investors to vote on any matter. Deloitte & Touche, in its comment letter, suggested that the Commission could minimize the burden imposed by the rule by requiring disclosure only when the stockholders vote on the approval or ratification of the company's accounting firm. Deloitte & Touche Letter. The disclosure rule serves a broader purpose than assisting shareholders in votes to ratify the selection of an auditor. The disclosure rule is one component of our auditor independence rules, the purpose of which is to promote the integrity of financial statements and promote investor confidence. Thus, the disclosure is aimed not only at a registrant's existing shareholders but at prospective shareholders as well.

[653] Tozzi Letter.

[654] CRE Report Card.

[655] See Section IV.G for further discussion of the disclosure requirement, including discussion of comments received concerning that requirement.

[656] As discussed in the Proposing Release (see Section II.C.4 and note 156 of this release), from 1978 to 1982, we required companies to disclose in their proxy statements all non-audit services provided by their auditors but later rescinded the requirement. Among other reasons, our review of proxy disclosures convinced us that accounting firms then, in contrast to now, were not providing extensive non-audit services to their audit clients. In addition, we noted that, even without the proxy statement requirement, investors had access to useful data provided to and made public by the SECPS.

[657] As noted above, the SECPS has stopped publishing information about audit firms' provision of non-audit services.

[658] See supra Section IV.G.

[659] See, e.g., Deloitte & Touche Letter; Cox Letter.

[660] See, e.g., Deloitte & Touche Letter. Deloitte & Touche stated in its comment letter that it "is difficult to estimate the average hours without an empirical study," but suggested that disclosure would require approximately three to six hours for companies with basic reporting systems and approximately 50-100 hours for companies with more complex reporting systems. As discussed below, we have modified the disclosure requirement, and we do not agree that the required disclosure will create more than a minimal additional burden to companies already preparing Schedules 14A or 14C.

[661] Cox Letter.

[662] CRE Report Card; AICPA Letter.

[663] See, e.g., Cox Letter.

[664] Id.

[665] See, e.g., CRE Report Card.

[666] See Deloitte & Touche Letter.

[667] We do not believe that the new disclosure requirement will cause registrants significant burdens associated with administrative tasks such as collecting, storing, and formatting the information, nor do we believe that compliance with the disclosure rule will require significant employee training.

[668] The proposed rule required disclosure of each professional service during the most recent fiscal year. Under the proposed rule, a service did not have to be disclosed if the fee for that service was less than $50,000 or ten percent of that registrant's audit fee. Commenters suggested that these thresholds were too low, and would result in disclosures of insignificant services. As adopted, the rule does not require disclosure of each professional service.

[669] As proposed, the rule would have required registrants to disclose whether the audit committee approved each disclosed non-audit service and considered the possible effect on the principal accountant's independence. As adopted, the rule requires disclosure of whether the audit committee considered whether the provision of the non-audit services by the principal accountant is compatible with maintaining the principal accountant's independence. We do not believe that this requirement imposes a significant burden.

[670] As noted above, audit committees currently receive information about the auditor's provision of non-audit services under ISB Standard No. 1 and SECPS Manual § 1000.08. See supra note 476.

[671] In its comment letter, the AICPA suggested that the proposed rule's definition of "affiliate of the accounting firm" created ambiguities that made the disclosure requirement potentially overbroad and burdensome. In response to commenters' concerns, we have removed the definition of "affiliate of the accounting firm" from the rule as adopted. Instead, the rule relies on

existing guidance concerning when an entity is associated with the accounting firm. We believe that, with this modification, the disclosure requirement in the final rule is targeted to its purpose and is not unduly burdensome.

[672] 15 U.S.C. § 77b(b); 15 U.S.C. § 78c(f); 15 U.S.C. 80a-2(c).

[673] See, e.g., KPMG Letter.

[674] See supra Sections III.C.1, III.C.3.

[675] See supra Section IV.B.1.

[676] See, e.g., Arthur Andersen Letter.

[677] Cf. Testimony of Alfred M. King, Valuation Research Corporation (July 26, 2000).

[678] See supra Section V.B.2(c).

[679] Id.

[680] 15 U.S.C. § 78w(a)(2).

[681] See, e.g., Arthur Andersen Letter; Deloitte & Touche Letter.

[682] See Deloitte & Touche Letter. As discussed above, some firms had already split off, or announced the split-off of, their consulting practices prior to our Proposing Release. The rule does not dictate any particular business model for accounting firms. Rather, firms remain free to determine their own structure, consistent with the law.

[683] See, e.g., Testimony of Wayne A. Kolins, National Director of Assurance, BDO Seidman, LLP (Sept. 20, 2000). As discussed in more detail in this release, we have removed the definition of "affiliate of the accounting firm" from the rule as adopted. Instead, the rule relies on existing guidance concerning when an entity is associated with the accounting firm. We believe that this modification addresses commenters' concerns in this area.

[684] See id.

[685] See, e.g., Testimony of Larry Gelfond, CPA, CVA, CFE, Colorado Accountancy Board, September 13, 2000 ("I do not believe that [the rule] will in any way hinder our [small] firm. In many respects, it may even benefit our firm. . . . I look at this, frankly, as an opportunity, particularly in the internal audit functions to step in, and given our experience, to work with management and with their respective independent auditor, let's say a Big Five firm, that this is an area that we can frankly look at as a new revenue generator.").

[686] See, e.g., AICPA Letter; Letter of David E. Pertl, Senior Vice President and CFO, First Choice, Inc. (Sept. 18, 2000); Letter of Kelly Schwarzbeck, CPA, Alexander X. Kuhn & Co. (Aug. 22, 2000); Letter of Robert L. Bunting (Sept. 6, 2000); Letter of Bruce C. Holbrook, Vice Chairman, Goodman & Company, LLP (July 25, 2000); Letter of William W. Traynham, CPA, President, Community Bankshares Inc. (Aug. 14, 2000).

[687] See, e.g., Letter of the California Chamber of Commerce (Sept. 15, 2000); Letter of Joseph C.

King, CPA, Faulkner & King, PSC (Sept. 13, 2000).

[688] See, e.g., Letter of Jeffry T. Herbst (Sept. 11, 2000); Letter of Richard P. Thornton (Sept. 13, 2000); Letter of Marc J. Garofalo, Mayor, Derby, Conn. (Sept. 18, 2000).

[689] See Compustat Database, October 31, 2000. The 85% figure excludes clients that are bank holding companies. For further analysis, see supra Section V.B (cost-benefit analysis).

http://www.sec.gov/rules/final/33-7919.htm
Last update: 12/01/2000

Commission has long considered auditor independence to be essential to reliable financial reporting and critical to the effective functioning of the U.S. capital markets.2 Independent auditors have an important public trust.3 Many Commission regulations require entities to file or. furnish financial statements that have been audited by an independent auditor; such entities. 2 See generally Proposed Rule: Revision of the Commissionâ€™s Auditor Independence Requirements, Release No. 33-7870 (June 30, 2000) (â€œ2000 Proposing Releaseâ€), available at https://www.sec.gov/rules/proposed/34-42994.htm. Ethics and Independence. Federal Statutes - Auditor Independence. Statues governing public company auditor independence include: Securities Exchange Act of 1934 - Section 10A - Audit Requirements.Â Release No. 33-7919 - Revision of the Commission's Auditor Independence Requirements. Release No. 33-8183 - Strengthening the Commission's Requirements Regarding Auditor Independence.Â Note: The PCAOB's rules and interim independence standards do not supersede the SEC's auditor independence rules. Therefore, to the extent that a provision of the SEC's rule is more restrictive - or less restrictive - than the PCAOB's interim independence standards, a registered public accounting firm must comply with the more restrictive rule. AA. A.