

unfair to determine the calculation of the *de minimis* exception based on the total fees paid to the accountant by the investment company because the resulting threshold would be so low; the practical effect would be no *de minimis* exception for investment companies. Therefore, the commenter suggested the threshold should coincide with the scope of the pre-approval requirement. We agree with the commenter and believe that the calculation of the *de minimis* exception should not relate solely to the level of services provided to the investment company. We have modified the proposed rule to determine the threshold based on the services provided to the investment company complex that were subject to the pre-approval requirements for the investment company's audit committee.

The proposed rules would require the audit committee to pre-approve all audit, review, and attest reports required under the securities laws. Section 32(a) of the Investment Company Act requires that a majority of the directors who are not interested persons appoint the independent accountant of the investment company. We requested comment on who should approve the selection of the accountant of the investment company, for example, the independent directors, the audit committee or both. One commenter¹⁷⁰ stated that the audit committee should select the accountant and the independent directors should ratify the selection, thereby retaining the independent directors as the ultimate decision making authority with respect to accountant selection. After consideration of these matters, we have determined to adopt the rules as proposed.

Also, as discussed later in this release, these provisions are supplemented as a result of the proxy disclosure requirements. We believe that disclosure of the procedures the audit committee uses to pre-approve audit services, as well as the disclosure of all non-audit services by category, including those meeting the *de minimis* exception stated above, will provide investors valuable information that may be used to evaluate the relationships that exist between the accountant and the audit client.

These rules apply to all audit, review, and attest services and non-audit services that are entered into after the effective date of these rules. For arrangements for non-audit services entered into prior to the effective date of these rules—regardless of whether or

not they were pre-approved by the audit committee—the accounting firm will have 12 months from the effective date of these rules to complete these services. For example, an engagement to provide non-audit services that was entered into in December 2002, which may or may not be complete by the effective date of these rules, is not subject to these rules, but must be completed within 12 months of the effective date of these rules. We believe these transition provisions will permit an orderly completion of existing engagements and permit accountants and audit committees adequate time to prepare to implement the new rules.

E. Compensation

We understand that some accounting firms offer their professionals cash bonuses and other financial incentives to sell products or services, other than audit, review, or attest services, to their audit clients. Such compensation arrangements may create a financial or other self-interest that could constitute a threat to the accountant's objectivity.¹⁷¹ These arrangements also may detract from audit quality by incentivizing the audit partner to focus on selling non-audit services rather than providing high quality audit services.

We also question whether a reasonable investor with full knowledge of such incentive programs would believe that the accountant could function with the independence and objectivity that is necessary for him or her to maintain, both in fact and in appearance. We are concerned that an accountant might be viewed as compromising accounting judgments in order not to jeopardize the potential for increased income from the act of selling non-audit services to the audit client. Because of this concern, we proposed that an accountant's independence would be deemed to have been impaired when he or she is compensated for selling or performing non-audit services for an audit client. Our proposed rule limited such compensation, direct or otherwise, that could be provided to any audit engagement team partner.

Commenters expressed two primary concerns with the proposals. First,¹⁷²

because the compensation was not directly related to sales activities, the operation of the rule would have been difficult given the size and nature of some firms' national and global operations. For example, read literally as proposed, a partner's compensation could not include a proportionate share of the accounting firm's overall profits, because some of those profits would be derived from the provision of non-audit services by other firm personnel. Second, some commenters¹⁷³ observed that the provisions were perceived to be overly broad because, as proposed, they would have applied to partners who provide specialized services and would have prevented them from being rewarded for selling or performing services in their area of expertise. For example, under the proposal an audit partner could be rewarded for selling audit, review or attest services; however, tax partners could not be rewarded for selling additional tax services to audit clients if they were members of the audit engagement team. That is, audit partners could be rewarded for selling within their own discipline, but tax partners could not.

We are addressing these concerns by clarifying that the compensation concerns exist where the audit partner's compensation is based on the act of selling non-audit services and specifying that the rule applies to audit partners. As described more fully in our discussion of definitions, the term audit partner refers to the lead and concurring partners and other partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee. In particular, audit partners, other than specialty partners, would include all audit partners serving the client at the issuer or parent.¹⁷⁴ Further, the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues are included within the definition of audit partner. Conceivably, "compensation" could include any form of cash or other assets distributed to the audit partner, including any income or benefit based

¹⁷¹ See, e.g., AICPA, *Practice Alert 99-1*, Guidance for Independence Discussions with Audit Committees, (May 1999).

¹⁷² See, e.g., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Deloitte & Touche, LLP, dated January 10, 2003; letter from Ernst & Young, LLP, dated January 6, 2003; letter from Federation des Experts Comptables Europeens, dated January 13, 2003; letter from Institute of Chartered Accountants in England and Wales, dated December 24, 2002; letter from KPMG, LLP, dated January 9, 2003; letter

from PricewaterhouseCoopers, dated January 8, 2003.

¹⁷³ See, e.g., letter from Ernst & Young, LLP, dated January 6, 2003; letter from Deloitte & Touche, LLP, dated January 10, 2003; letter from KPMG, LLP, dated January 9, 2003; letter from McGladrey & Pullen, LLP, dated January 9, 2003.

¹⁷⁴ As discussed previously, partners who provided ten or fewer hours of service are excluded from the definition of audit partner.

¹⁷⁰ See, letter from Investment Company Institute, dated January 13, 2003.