



**MUTUAL FUND DIRECTORS FORUM**  
*The FORUM for FUND INDEPENDENT DIRECTORS*

December 13, 2011

Office of the Secretary  
PCAOB  
1666 K Street, NW  
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 37

Dear Board:

The Mutual Fund Directors Forum<sup>1</sup> (“the Forum”) welcomes the opportunity to respond to the request for comments by the PCAOB (the “Board”) on its recent concept release discussing mandatory audit firm rotation (“Concept Release”).<sup>2</sup>

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern. Mutual fund independent directors, particularly those independent directors who sit on audit committees, share the Board’s interest in a robust financial reporting process and good audit quality and therefore are keenly interested in how the issues discussed in the concept release will impact investment company shareholders.

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## **I. Summary**

The Concept Release seeks comment on whether mandatory audit firm rotation would enhance auditor independence, objectivity and professional skepticism. Yet the release cites no empirical evidence – and the Forum is aware of none – showing that

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<sup>1</sup> The Forum’s current membership includes over 650 independent directors, representing 98 independent director groups. Each member group selects a representative to serve on the Forum’s Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum’s Board of Directors, although it does not necessarily represent the views of all members in every respect.

<sup>2</sup> *Concept Release on Audit Independence and Audit Firm Rotation; Notice of Roundtable*, PCAOB Release No. 2011-006, PCAOB Rulemaking Docket Matter No. 37 (August 16, 2011).

mandatory audit firm rotation has any positive impact upon auditor independence, objectivity, and skepticism. The proposal would, however, raise costs to shareholders. The Forum sees no justification for imposing additional shareholder costs in return for speculative potential benefits.

The Forum believes that mandatory firm rotation would impair the ability of an audit committee to do its important work, a result contrary to the express purpose of recent regulatory initiatives designed to strengthen the responsibilities and independence of audit committees. Further, mandatory auditor rotation could critically damage the ability of mutual funds to obtain the high quality and specialized audit services required. In sum, the concept of mandatory audit firm rotation represents a potentially costly initiative that would reduce the choices available to fund boards for audit services without empirical evidence that it would have a positive impact on auditor independence, objectivity, and skepticism. Consequently, mandatory audit firm rotation is not in the best interests of fund shareholders and the Forum respectfully opposes the concept.

## **II. Fund Independent Directors**

Under the federal securities laws, mutual funds are overseen at two levels. At the federal level, the Securities and Exchange Commission (“SEC”) oversees and regulates the activities of funds pursuant to the Investment Company Act of 1940 (“1940 Act”). In addition, funds also have a second layer of oversight – an independent board of directors (or trustees) that oversees the management of each fund on behalf of its shareholders. Under the 1940 Act, a fund’s independent auditor must be selected each year at an in-person meeting by a majority of the fund’s independent directors. As a practical matter, the involvement of fund independent directors with the audit team is significant. For example, the Sarbanes-Oxley Act of 2002 mandates rotation of the lead and concurring audit partner every five years.<sup>3</sup> When audit partners are required to rotate off the audit engagement, the fund independent directors approve the proposed replacement audit partners.

Independent directors represent a coming together of a fund’s investors to collectively supervise their investment. Because fund independent directors have detailed knowledge of the funds they oversee, they are able to respond flexibly and quickly to the specific issues faced by their funds. The ability of fund audit committees to act in a manner best suited to the shareholders’ needs is a critical component of the statutory scheme governing funds.

## **III. Audit Committee Oversight**

Since the federal securities laws were originally enacted, regulators have focused on ensuring that a strong and engaged board, particularly the audit committee of the board, oversees the accounting and financial reporting processes of the issuer as well as the

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<sup>3</sup> Release No. 33-8183 (January 28, 2003).

independent audits of the issuer's financial statements.<sup>4</sup> In the investment company context, Section 32(a) of the 1940 Act provides that the independent auditors must be selected each fiscal year by a majority vote of the independent directors at an in-person meeting. Because virtually all fund audit committees are independent of fund management, no shareholder ratification of the board's decision is required.<sup>5</sup>

Regulators, as well as the auditing and business communities, have long sought to promote effective and independent audit committees. The consistent regulatory objective has been for the audit committee to play "a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system."<sup>6</sup> For example, the Sarbanes-Oxley Act of 2002 resulted in new requirements for all listed companies related to matters such as the independence of audit committee members, the audit committee's responsibility to select and oversee the issuer's independent auditor, and funding for the independent auditor and any outside advisors engaged by the audit committee. While these Sarbanes-Oxley provisions only apply to listed companies, they have commonly been adopted by investment company audit committees.<sup>7</sup>

The purpose of these changes was to further strengthen the ability of the audit committee to provide "independent review and oversight of a company's financial reporting processes, internal controls and independent auditors."<sup>8</sup> As the SEC has noted,

By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices.<sup>9</sup>

The Sarbanes-Oxley Act also required all registered investment companies to either identify and disclose the name of at least one audit committee member who is an "audit committee financial expert," or explain why the audit committee lacks such an expert. The purpose of such a person, the SEC explained, is to serve as a resource for the audit committee in carrying out its functions.<sup>10</sup> The practical result of this disclosure obligation has been for virtually all fund audit committees to have at least one designated audit committee financial expert.

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<sup>4</sup> Section 3(a)(58) of the Exchange Act (15 U.S.C. 78c(a)(58)).

<sup>5</sup> Rule 32a-4 under the 1940 Act exempts investment companies from obtaining shareholder approval of the selection of independent accountants if the fund has an audit committee composed entirely of independent directors and the audit committee has adopted a written charter.

<sup>6</sup> Release 33-8220, Standards Relating to Listed Company Audit Committees, effective date April 25, 2003.

<sup>7</sup> Robertson, *Fund Governance Legal Duties of Investment Company Directors*, section 4.04; A.B.A. Section of Bus. L., *Fund Director's Guidebook* 15-17 (2006).

<sup>8</sup> Release 33-8220.

<sup>9</sup> Release 33-8220.

<sup>10</sup> Investment Company Act Rel. No. 25775 (Oct. 22, 2002).

Several times in the past, the existence of well-functioning audit committees has been judged sufficient to encompass any perceived benefits of mandatory audit firm rotation, without the increased costs that the release notes will inevitably accompany such a regulatory move. For example, in 1978 the AICPA's "Cohen Commission" recommended against mandatory audit firm rotation, noting that the audit committee would be in the best position to determine, under the facts and circumstances of each individual company, whether a change in auditor would be appropriate.<sup>11</sup> Similarly, Congress considered, but rejected, including the requirement in the Sarbanes Oxley Act of 2002, instead determining to enhance and strengthen audit committee independence as well as require mandatory rotation of the lead and concurring audit partner ever five years.

The Sarbanes-Oxley Act also required the GAO to study the potential effects of mandatory audit firm rotation. In 2003, the GAO concluded that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality."<sup>12</sup> Instead, the GAO highlighted the important role that audit committees play in enhancing auditor independence and audit quality. As the GAO noted, if audit committees regularly evaluate whether audit firm rotation would be beneficial and are actively involved in helping to ensure auditor independence and audit quality, many of the intended benefits of audit firm rotation could be realized at the initiative of the audit committee.<sup>13</sup>

#### **IV. The Critical Importance of Well-Functioning Fund Audit Committees**

The relationship between a fund's audit committee and its independent auditors is critically important. The two work together to build a shared understanding of the control environment and the personnel at the firm. The relationship allows the audit committee to gain additional, independent insight into the fund's risk control environment, the internal accounting processes, and other important matters. To get the full benefit of the information flow, the independent auditor and the audit committee must have a shared trust and confidence which is developed over time.

The relationship is particularly important in the investment company context. Each year the audit committee evaluates whether to continue the engagement or to hire new independent auditors. Under the statutory scheme, the independent directors of the board are responsible for, under the unique facts and circumstances of each fund, determining whether shareholders would be served best by retaining the current outside auditors or replacing them. Requiring mandatory audit rotation would disrupt this appropriately crafted regulatory approach, which recognizes that the various and changing circumstances at each fund complex require the audit committee members to make an independent evaluation of how the audit relationship can best serve shareholders going forward.

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<sup>11</sup> The Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations xi (1978) ("Cohen Commission Report") at 109.

<sup>12</sup> November 2003 report, Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation (GAO-04-216) at 8.

<sup>13</sup> Id. at 9.

Importantly, it takes time for an audit firm to become sufficiently familiar with the fund to be of optimal help to the audit committee. Mandatory audit firm rotation might well require an audit firm transition just as the audit committee has achieved an effective working relationship with the outside auditors. Such a result is not in the best interests of fund shareholders. The Concept Release provides little justification for superseding the judgment of an audit committee and independent directors of how best to manage the relationship with the independent auditor.

The Concept Release appears to be aimed at issues not relevant to investment companies. For example, the Release asks whether mandatory rotation might “dramatically reduce” what it sees as an inherent distortion of the system – the entity paying for the audit is the one creating the financial statements being audited. Yet in the investment company context, the independent directors who select the auditor are directors of the fund, and the audit fees are paid from the fund. It is the adviser or a third party whose personnel prepare the financial statements, yet those entities do not select the auditor.

## **V. Mandatory Audit Firm Rotation is Not in the Best Interests of Fund Shareholders**

Question 6 of the Concept Release asks whether there are reasons for applying an audit firm rotation requirement only to companies in certain industries. Sound reasons to exempt the mutual fund industry from any audit firm rotation requirement.

### **A. Few Audit Firms and a Specialized Area Mean Fewer Available Eligible Firms**

The structure and nature of investment company operations are quite different from other reporting issuers. Investment company audits require specialized knowledge, especially in the area of valuation of portfolio securities. There is a separate audit guide for investment companies, as well as unique regulatory requirements. As a result of the unique nature of the industry, fewer firms have developed expertise in auditing investment companies than those available to audit operating companies.

The problem of relatively few audit firms with the appropriate level of expertise in this area is exacerbated by the fact that some of the otherwise qualified audit firms may have a financial business relationship with the fund complex, such as lines of credit with a bank or management of the audit firm’s retirement plan, which may render the firm not independent with respect to the audit of the fund. Financial business relationships can also suddenly create independence issues when the fund complex, as part of normal business operations, develops new affiliations, merges, or in some other manner changes a portion of its business relationships. The limited universe of appropriately qualified audit firms can be particularly significant when the fund is part of a broadly diversified financial services enterprise. In such cases, consulting services provided to other portions of the enterprise can be financially much more significant than audit fees, which in turn will cause individual accounting firms to view the fund as an undesirable audit client. These factors,

combined with the relatively small size of the available pool of qualified, high quality audit firms that possess the requisite expertise to audit mutual funds, mean that mandatory firm rotation would present a significant issue for many investment companies.

### **B. In Practice, Many Fund Complexes Use Several Audit Firms**

The Concept Release appears to suggest that one benefit of mandatory audit firm rotation would be to bring a different auditor's viewpoint to the engagement. Yet many fund complexes already engage several audit firms and thus already have the benefit of multiple viewpoints when the independent directors believe it important to do so. For example, it is not uncommon a mutual fund complex to use two audit firms to audit the funds. The independent fund directors of these complexes have determined that, for the complex they oversee, this is the best arrangement for fund shareholders. In addition, although not required under the 1940 Act, some fund audit committees have adopted the practice of using a different audit firm to audit the funds than that which audits the funds' advisor.

These practices, which are not formally required under the securities laws and regulations, have been judged by the independent directors of some fund audit committees to be in the best interests of their fund shareholders, given the unique facts and circumstances of each individual fund. However, particularly in view of the relatively limited available pool of qualified high quality audit firms with expertise in the investment company area, a requirement of mandatory audit firm rotation might well make it impossible for audit committees voluntarily to engage the services of multiple audit firms, because at the time of the mandatory firm rotation, there may well not be multiple alternative firms available that are independent. The Concept Release offers no justification for diminishing the ability of independent fund directors to make the auditor selections they deem to be in the best interests of fund shareholders.

### **C. Individual Funds Have Various Fiscal Year Ends**

By their very nature, investment company complexes do not file a single set of quarter or year-end statements, as do other reporting entities. Instead, each fund or series of funds in an investment company complex has its own filing requirements. Different funds within a single complex often have different year-ends. Therefore, it would be difficult to identify a natural cut-off date at which it would be appropriate to change the audit firm. Rather, in a complex with many different fiscal year ends, there would need to be a period of auditor overlap. For a period of time, both audit firms would need to be in place, reviewing and testing internal controls of the fund complex. This duplication would not occur as a result of a decision by the audit committee that doing so would benefit shareholders; rather it would stem solely from an arbitrary rule. The result would be costly to shareholders and disruptive to fund management as well as to audit committee oversight of the fund's accounting and financial reporting processes.

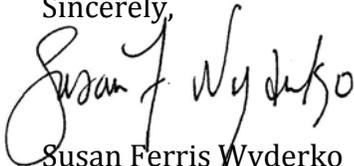
#### **D. Fund Shareholders Should Not Be Financially Penalized for a Speculative Result**

The Concept Release appears to implicitly concede that the early years of an auditor-client relationship pose higher audit risks than other years.<sup>14</sup> It also admits that there is no evidence that mandatory audit firm rotation will significantly enhance auditors' objectivity and independence.<sup>15</sup> While the benefits of mandatory firm rotation are speculative, rotation would clearly increase mutual fund investors' costs as new audit personnel are brought on, and the audit committee and fund management work to establish new relationships with entirely new personnel. For mutual fund shareholders, the costs of such a requirement would appear to far outweigh the speculative goal advanced by the proposal, that theoretically, such a move would enhance auditors' objectivity. Therefore, we do not believe this result would be in the best interests of fund shareholders.

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We look forward to continuing to participate in this ongoing discussion, as independent directors have an important role to play in fostering healthy audit environments. If you would like to discuss our comments further, please feel free to contact us at 202-507-4488.

Sincerely,



Susan Ferris Wyderko  
Executive Director

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<sup>14</sup> Release at p. 24.

<sup>15</sup> Id. at 17.