IIC 99-1, Supplement No. 1 In June 1999, the IIC decided not to add this project to its agenda: "Non-Diversified Mutual Funds": Under What Circumstances Do They Qualify as "Indirect" Financial Interests?

Independence Standards Board. Independence Issues Committee

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ISSUE SUMMARY - "NON-DIVERSIFIED MUTUAL FUNDS": UNDER WHAT CIRCUMSTANCES DO THEY QUALIFY AS "INDIRECT" FINANCIAL INTERESTS?

IIC-99-1 Supplement No.1

This supplement is provided to assist the Committee in focusing on the specific issues that should be addressed on this topic.

Issue 1

On what basis should an investment made by a Non-Diversified Mutual Fund ("Fund") be evaluated to determine whether it should be deemed an indirect financial interest of a member?

View A – Whether the member has no influence over the content of the Fund's investment portfolio.

Those who support this view believe that the member could only have a direct financial interest in the Fund as a whole, rather than in any of the Fund's individual investments, because the member has no influence over the Fund's investment decisions. This view would prevail even if the portfolio held relatively few investments. A member's decision to invest in any mutual fund is commonly based on the mutual fund's investment objectives (i.e., growth, fixed income, high technology, health care, etc.) which would not address investments in the securities of specific companies. The member would know that the Fund could, at any time, buy or sell a security of any company consistent with such objectives. Further, the member's investment in the Fund would be impacted by the aggregate performance of all of the Fund's investments, not just those that may be audit clients.

View B – Whether the investment is "relatively significant" to the Fund based either on the relative value of the individual investment to the Fund's total assets or the percentage of outstanding voting securities of the issuer.

Those who support this view believe that the specific content of a fund matters at some threshold level, and that when a member invests in a Fund that he or she knows has a relatively significant investment in one or more of his or her audit clients, the member has made a conscious decision to invest a portion of his or her investment in those audit clients. Such a decision should be deemed, for all intents and purposes, equivalent to making a direct financial interest.

Issue 2a

If View B were adopted in relation to Issue 1, when would an individual investment of a Fund be deemed "relatively significant" to the Fund?

View A – When either the relative value of the securities compared to the Fund's total assets or the percentage of outstanding voting securities of the issuer is 5% or more. For example, for funds containing fewer then 20 investees, that concentration would result in at least one such investee exceeding the 5% threshold.

Proponents of this view believe that 5% or more of either measure is significant because at that point it would generally be material to the Fund or at this level of investment the investee would be deemed an "affiliated company" of the Fund under the Investment Company Act of 1940.

View B – When the Fund has the ability to exercise significant influence over the investee, which would be presumed to exist when the percentage of outstanding voting securities of the issuer is 20% or more.

Proponents of this view believe that any passive investment of a Fund should not be deemed significant for this purpose. However, an investment in which the Fund has obtained significant influence is likely to be of a long-term investment nature and, therefore, different from an investment the Fund may sell at any time.

View C – When the relative value of the securities compared to the Fund's total assets exceeds a threshold higher than that of View A (for example, 10% or 20%).

Proponents of this view believe that, while the 5% test of View A is too low, at some higher level (e.g., 10% or 20 %), a Fund's concentration becomes sufficient to warrant treatment as a direct financial interest.

Issue 2b

If View B were adopted in relation to Issue 1, when would the portion of the individual investments of a Fund that are audit clients of the member be deemed inappropriately concentrated to the Fund?

View A – Such a determination should be made on an investment-by-investment basis using the measurement criterion established in Issue 2a.

Proponents of this view believe that the determination of a member’s independence with respect to one audit client should not be impacted by its independence with respect to another unrelated audit client.

View B – When such proportion represents more than 75% of the Fund’s investments.

Proponents of this view acknowledge that since a relatively small number of firms audit the vast majority of public companies, it is quite possible that a single firm might audit a significant proportion of a given registered mutual fund’s investments. Nonetheless, a member may lose the appearance of independence when he or she obtains a financial interest in a Fund whose investments are in the substantial majority (for example, more than 75%, measured by investment amounts) audit clients of the member’s firm. Further, AICPA Ethics Ruling No.109 states that: "…an investment in a financial services product that invests *only* in clients of the member is considered to be a direct financial interest in such client, and independence would be considered to be impaired." (emphasis supplied)

Issue 3

If a fund were structured to convey to its owners an actual pro-rata portion of the individual securities in its portfolio**,** rather than the likely much more common undivided share of the total portfolio, should investment in the Fund be considered to be investment by the member in the underlying securities?

View A –The investment should be considered to be directly in the underlying securities because, in essence, that's what a pro-rata portion is. While delivery in-kind of an investor's share of the investees may be permitted, it is not required to be classified as investment in the underlying securities.

View B – The nature of the owner's interest in the underlying securities is not considered a substantive enough factor to change an otherwise indirect interest into a direct one.

Issue 4

To what extent should a member be obligated to monitor the investments made by a Fund to determine that such investments remain indirect financial interests?

View A – The member should be obligated to monitor the investments of the Fund.

Those who support this view believe that when a Fund makes a relatively significant investment in a member's audit client after the member has made an investment in the Fund, a change in circumstances has occurred that may impact the member's independence with respect to that client. The member must be aware of such changes in order to appropriately assess independence from that day forward, not unlike the assessment an accounting firm must undertake when it obtains a new audit client.

View B – The member should not be obligated to monitor the investments of the Fund.

Those who support this view argue that the member has made an investment in the Fund, rather than in the individual components of the Fund's investment portfolio. Such components would be bought and sold consistent with the Fund's investment objectives. Further, establishing a constant requirement to monitor the Fund's investments is likely to be impractical and untimely, resulting in frequent unavoidable violations by a member that have no real impact on whether the member or his or her firm is independent of the audit clients in which the Fund invests. Any monitoring requirement established would need to acknowledge that unavoidable violations are permitted. Absent such a clause, the only practical approach would be to proscribe members from investing in Non-Diversified Mutual Funds altogether.

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