

**MEMO# 32137**

January 10, 2020

# SEC Proposes Amendments to Auditor Independence Rule

[32137]

January 10, 2020 TO: ICI Members

Investment Company Directors SUBJECTS: Audit and Attest

Audit Committees

Compliance RE: SEC Proposes Amendments to Auditor Independence Rule

On December 30, the Securities and Exchange Commission issued for public comment proposed amendments to its auditor independence rule.[\[1\]](#) The proposed amendments are intended to update certain elements of the rule so that relationships and services that do not pose threats to the auditor's objectivity and impartiality do not trigger non-substantive violations or potentially time-consuming audit committee review of non-substantive matters.

The proposed amendments would: i) amend the definitions of "affiliate of the audit client" and "investment company complex" to add materiality qualifiers to the analysis of entities under common control; ii) amend the definition of "audit and professional engagement period" to shorten the look-back period for domestic first time filers; iii) add certain student loans and de minimis consumer loans to the categorical exclusions from independence impairing lending relationships; iv) replace the reference to "substantial stockholders" in the business relationship rule with the concept of beneficial owners with significant influence; and v) replace the transition and grandfathering element of the rule with a framework to address inadvertent independence violations that arise as a result of merger and acquisition transactions. Comments on the proposal are due to the SEC 60 days following publication in the *Federal Register*.[\[2\]](#)

## I. Background

The SEC recently adopted amendments to the "Loan Provision" of the auditor independence rule addressing lending relationships between an auditor and certain shareholders of an audit client.[\[3\]](#) At that time, the SEC solicited comment on other potential updates to the auditor independence rule.[\[4\]](#) The proposed amendments reflect feedback received from the public as well as the SEC's experience administering the auditor independence rule since its initial adoption. Among other things, the proposed amendments address the common control element of the auditor independence rule and may reduce the impact the rule has on auditor choice in the private equity and investment company industries.

## **II. Proposed Amendments**

### **A. Affiliate of the Audit Client and Investment Company Complex**

The term “audit client” is currently defined as the entity whose financial statements or other information is being audited, reviewed or attested and any affiliates of the audit client. “Affiliate of the audit client” includes, in part, 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. Affiliate of the audit client also includes each entity in the investment company complex (“ICC”) when the audit client is an entity that is part of an ICC. The term “investment company complex” is currently defined, in part, as a) an investment company and its investment adviser or sponsor, b) any entity controlled by or controlling the investment adviser or sponsor, and c) any entity under common control with the investment adviser or sponsor 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.

Under these definitions, entities under common control with the audit client (“sister entities”) are considered affiliates and fall within the definition of audit client. Additionally, each entity in an ICC is considered an affiliate when the audit client is part of the ICC. The Proposing Release indicates that the SEC has observed a number of situations where a prohibited service or relationship with a sister entity did not result in a corresponding threat to the auditor’s objectivity and impartiality. To address these situations, the proposal would amend the definitions of affiliate of the audit client and ICC to include materiality qualifiers in the respective common control provisions and to distinguish how the definitions apply when an accountant is auditing a portfolio company,[\[5\]](#) an investment company, or an investment adviser or sponsor.

Specifically, according to the proposal, when the entity under audit is an investment company or an investment adviser or sponsor, the auditor should look to the proposed ICC definition to determine which entities are affiliates of the audit client. When the entity under audit is a portfolio company, the proposal clarifies that the auditor should look to the proposed definition of affiliate of the audit client to determine which entities are affiliates of the audit client.

#### *1. Proposed Amendments for Common Control and the Affiliate of the Audit Client*

The proposal amends the definition of affiliate of the audit client to include a materiality requirement with respect to operating companies under common control. With respect to the application of the affiliate of the audit client definition to operating companies, including portfolio companies, the proposal focuses the independence analysis on sister entities that are material to the controlling entity.

#### *2. Proposed Amendments to the Investment Company Complex*

The proposed amendments would reference the entity under audit as the starting point for the analysis of which entities are to be considered part of the ICC. As a result, when the entity under audit is an investment company, an investment adviser or a sponsor, the auditor would focus solely on proposed Rule 2-01(f)(14) to determine what other entities are a part of the ICC and, therefore, affiliates of the audit client.

#### a. Unregistered Funds

The proposed amendments would include within the meaning of the term investment company, for purposes of the ICC definition, entities that would be investment companies but for the exclusions provided by section 3(c) of the Investment Company Act. As such, ICC would include registered investment companies, business development companies, and private funds. This change would more effectively focus the independence analysis for unregistered funds under audit and align with the analysis to be undertaken for registered investment companies.

#### b. Common Control with any Investment Company, Investment Adviser or Sponsor

Currently any entity under common control with an investment adviser or sponsor of an investment company audit client that is also an investment adviser or sponsor ("sister investment adviser") is considered part of the ICC, and thereby an affiliate of the audit client. Additionally, the current ICC definition includes any investment company advised by a sister investment adviser. Accordingly, an auditor to an investment company cannot have any prohibited services or relationships with any of the sister investment advisers or any investment companies they advise.

The proposal would align the common control prong of the proposed ICC definition with the common control prong for operating companies discussed above. Specifically, proposed 2-01(f)(14)(i)(D)(1) of the ICC definition includes only sister investment advisers and investment companies they advise that are material to the controlling entity. The Proposing Release indicates that inclusion of a materiality qualifier may broaden the pool of prospective accountants the investment company audit client may engage as its auditor.

The Proposing Release notes that other elements of the auditor independence rule already include materiality qualifiers and auditors should therefore be familiar with performing materiality evaluations. The Proposing Release also notes that a determination that sister entities are not material to the controlling entity, by itself, does not conclude the independence analysis because of the "all facts and circumstances" general standard in Rule 2-01(b).

#### c. Investment Companies that Share an Investment Adviser or Sponsor Included Within the ICC Definition

The proposal would require an auditor to consider as part of its independence analysis sister investment companies that have the same investment adviser or sponsor as the investment company under audit, regardless of whether such sister investment companies are material to the shared investment adviser or sponsor. The Proposing Release indicates that the nature of the relationship between an investment adviser and the investment companies it advises is such that once an investment adviser is included within the ICC, the investment companies it advises should be included as well.

#### d. Significant Influence within the ICC Definition

The proposed ICC definition includes a significant influence prong similar to that included in the current definition of affiliate of the audit client. The proposed significant influence prong includes a materiality qualifier. The Proposing Release indicates that the adopting release for the Loan Provision described significant influence in the investment company context

and that analysis would apply in the ICC definition.[\[6\]](#)

## **B. Proposed Amendment to Audit and Professional Engagement Period**

The proposed amendments would shorten the look-back period for domestic first-time filers in assessing compliance with the auditor independence requirements from three years to one year. The proposal would define “audit and professional engagement period” so that a first-time filer, whether a domestic issuer or a foreign private issuer, would apply the auditor independence rule beginning with the most recently completed fiscal year.

## **C. Proposed Amendments to Loans or Debtor-Creditor Relationships**

Currently certain loans from a financial institution to the audit firm’s covered persons under its normal lending procedures are excepted from the prohibition on loans from the audit client. Such loans include, for example, loans fully collateralized by the cash surrender value of a life insurance policy, a mortgage loan collateralized by the borrower’s primary residence, and credit card balances reduced to \$10,000 or less. The proposal would add student loans to the types of loans that are excepted from the prohibition on loans, provided the loan was obtained by the individual prior to becoming a covered person in the firm. Consistent with recommendations submitted by ICI and IDC the proposal would broaden the credit card exception so that it covers any consumer loan reduced to \$10,000 or less.

## **D. Proposed Amendments to the Business Relationships Rule**

The business relationships rule prohibits, at any point during the audit and professional engagement period, the accounting firm or any covered persons from having 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 audit client’s officers, directors, or substantial stockholders. The proposal would replace the term “substantial stockholders” with the phrase “beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client.” The proposed change would align the business relationships rule with recent changes to the Loan Provision.

Because the definition of audit client includes affiliated entities, the business relationships rule also prohibits relationships with affiliates. The proposal would narrow the application of the rule as it relates to persons in a decision-making capacity. Specifically, the Proposing Release indicates that the analysis of persons in a decision-making capacity is limited to the entity under audit. The Proposing Release also indicates that, as to the proposed change noted above from “substantial stockholders” to “beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client” the independence analysis should focus on whether the beneficial owner has significant influence over the entity under audit.

The Proposing Release provides this same clarification to the recently adopted amendments to the Loan Provision. That is, the analysis required under the Loan Provision’s references to “an audit client’s officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client” should focus on the entity under audit.

## **E. Proposed Amendments for Inadvertent Violations for Mergers and Acquisitions**

The proposal replaces the outdated transition and grandfathering provisions in the rule with a transition framework to address inadvertent violations that arise only as a result of merger or acquisition transactions. The proposal provides that an auditor's independence would not be impaired because of an audit client's merger or acquisition provided the auditor satisfies certain conditions. These conditions require the audit firm to correct the independence violations as promptly as possible and maintain a quality control system for monitoring audit clients' merger and acquisition activity and for prompt identification of potential independence violations.

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### **endnotes**

[1] *Amendments to Rule 2-01, Qualifications of Accountants*, Release No. 33-10738 (December 30, 2019) ("Proposing Release") available at <https://www.sec.gov/rules/proposed/2019/33-10738.pdf>.

[2] To date, the *Federal Register* has not published the proposal.

[3] See [ICI Memorandum No. 31823](#) (June 24, 2019).

[4] ICI and the Independent Directors Council ("IDC") filed a joint comment letter on the SEC's proposed amendments to the Loan Provision. See [ICI Memorandum No. 31281](#) (July 9, 2018).

[5] "Portfolio company" refers to an operating company in which an investment company or unregistered private equity fund invests.

[6] See Proposing Release at 23.