

MEMO# 32853

October 22, 2020

SEC Adopts Amendments to Auditor Independence Rule

[32853]

October 22, 2020 TO: ICI Members

Investment Company Directors

Accounting/Treasurers Committee SUBJECTS: Audit and Attest

Audit Committees RE: SEC Adopts Amendments to Auditor Independence Rule

The Securities and Exchange Commission recently adopted amendments to its auditor independence rule 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 immaterial matters.[\[1\]](#) The amendments will take effect 180 days after they are published in the *Federal Register*.

Adopted substantially as proposed, the amendments to Rule 2-01 of Regulation S-X:i) amend the definitions of "affiliate of the audit client" and "investment company complex" to add a materiality qualifier 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 relationships; iv) replace the reference to "substantial stockholders" in the business relationships rule with the concept of beneficial owners with significant influence; and v) replace the transition and grandfathering provision in the rule with a transition framework to address inadvertent independence violations that arise only as a result of the merger or acquisition transactions. The amendments also make changes to the loan provision to conform it to certain staff guidance described in the proposing release.[\[2\]](#)

ICI and IDC filed a joint comment letter on the proposal strongly supporting many of the proposed amendments, including the addition of a materiality qualifier to the analysis of entities under common control.[\[3\]](#)

Affiliate of the Audit Client

The term "audit client" is defined as the entity whose financial statements or other information is being audited, reviewed or attested and any affiliates of the audit client. The term "affiliates of the audit client" is defined to include, 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, and each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

Under current Rule 2-01, the requirement to identify and monitor for potential independence-impairing relationships and services applies to affiliated entities, including sister entities, regardless of whether the sister entities are material to the controlling entity. This same requirement to identify and monitor for potential independence-impairing relationships and services applies to entities, including sister entities that are part of an investment company complex (ICC).

The SEC proposed amending the definition of affiliate of the audit client to include a materiality qualifier with respect to operating companies, including portfolio companies,^[4] under common control and to clarify the application of the definition to operating companies and direct auditors of an investment company or investment adviser to the ICC definition. Under the proposal, a sister entity would be deemed an affiliate of the audit client unless the entity is not material to the controlling entity.

In a change from the proposal, the final amendments incorporate a “dual materiality” threshold such that a sister entity will be included as an affiliate of the audit client if the sister entity and the entity under audit are each material to the controlling entity. Under the final amendments, if either the sister entity or the entity under audit is not material to the controlling entity, then the sister entity will not be deemed an affiliate of the audit client.

Investment Company Complex

The SEC proposed including a materiality qualifier in the common control provision of the ICC definition to align with the proposed amendments to the affiliate of the audit client definition. To further align with the affiliate of the audit client definition, the SEC proposed including a significant influence provision in the ICC definition. Both of these proposed amendments were meant to provide consistency across the affiliate of the audit client definition and the ICC definition in light of proposed amendments specifying that auditors of an investment company or investment adviser would apply the ICC definition to identify affiliates. Under the proposal investment companies that share an investment adviser would continue to be affiliates, regardless of whether such sister investment companies are material to the shared adviser. The SEC also noted that while the proposed amendments to the ICC definition introducing a materiality qualifier would alter the composition of entities that would be deemed affiliates of the audit client, the general independence standard in 2-01(b)^[5] would continue to apply.

The amendments adopted to the ICC definition incorporate the dual materiality threshold in the common control provision, consistent with the amendments to the to the common control provision in the affiliate of the audit client definition. The Adopting Release indicates that the Commission was persuaded that the dual materiality threshold for identifying common control affiliates will be equally helpful in reducing compliance challenges in the ICC context.

Where a sister investment company shares the same investment adviser as an investment company under audit, the definition of ICC continues to treat the sister investment company as part of the ICC, regardless of whether such sister investment company is material to the shared investment adviser. Similarly, when a sister investment adviser is included in the ICC under the dual materiality threshold, the investment companies advised by the sister investment adviser are included in the ICC under the amendments adopted.

Consistent with the original proposal the final amendments to the ICC definition: i) include the significant influence provision; ii) indicate that common control entities engaged in the business of providing administrative, custodian, underwriting, or transfer agent services are a part of the ICC if they provide services to investment companies or investment advisers in the ICC; and iii) include within the definition of investment company any entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940.

The ICI/IDC Letter recommended that the SEC consider providing guidance or scenarios illustrating the interaction of the amended affiliate of the audit client definition and the amended ICC definition in any adopting release. The Adopting Release provides five examples with schematics illustrating the operation of the revised definitions.

Other Amendments

The SEC adopted largely as proposed amendments: i) defining “audit and professional engagement period” to shorten the look-back period for domestic first-time filers; ii) replacing the reference to “substantial stockholders” in the business relationships rule with the concept of beneficial owners with significant influence; and iii) replacing the transition and grandfathering provision in the rule with a transition framework to address inadvertent independence violations that arise only as a result of merger or acquisition transactions. The SEC also adopted proposed amendments adding certain student loans and de minimis consumer loans to the categorical exclusions from independence impairing relationships. Consistent with recommendations in the ICI/IDC Letter, the amendments add student loans to a covered person’s immediate family members to the categorical exclusions.

Loan Provision

Currently the loan provision provides that 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 any loan to or from an audit client, or 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, except for specified types of loans obtained under normal lending procedures and terms.[\[6\]](#)

The Proposing Release provided guidance on the application of the loan provision. Specifically, the Proposing Release indicated that when an auditor is evaluating lending relationships with officers, directors, or beneficial owners with significant influence over an affiliate of the entity under audit, the auditor should focus on whether significant influence exists at the entity under audit.[\[7\]](#) The ICI/IDC Letter recommended that any adopting release reiterate the guidance so that auditors and their audit clients understand the nature of the analysis to be performed. Consistent with our recommendation, the final amendments revise the rule text relating to the loan provision to conform it to the guidance described in the Proposing Release.

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endnotes

[1] See *Qualifications of Accountants*, Release Nos. 33-10876, IC 34052, (October 16, 2020) (Adopting Release) available at <https://www.sec.gov/rules/final/2020/33-10876.pdf>.

[2] See *Amendments to Rule 2-01, Qualification of Accountants*, Release Nos 33-10738, IC 33737 (December 30, 2019) (Proposing Release) available at <https://www.sec.gov/rules/proposed/2019/33-10738.pdf>.

[3] See *ICI/IDC File Comment Letter on SEC Auditor Independence Proposal*, [Memorandum No. 32296](#) (March 17, 2020) (“ICI/IDC Letter”).

[4] The term “operating company” refers to entities that are not investment companies, investment advisers, or sponsors, and the term “portfolio company” refers to an operating company that has investment companies or unregistered funds in private equity structures among its investors. Generally, an auditor to a portfolio company would identify affiliates using the affiliates of the audit client definition rather than the investment company complex definition.

[5] Rule 2-01(b) provides that the SEC will not recognize an accountant as independent if 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.

[6] See Rule 2-01(c)(1)(ii).

[7] Proposing Release at pp. 34-37.