pwc

June 29, 2018

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: File No. S7-10-18

Dear Mr. Fields:

We appreciate the opportunity to comment on the Securities and Exchange Commission's (SEC or "the Commission") proposed rule - *Auditor Independence with Respect to Certain Loans or Debtor - Creditor Relationships* (the "proposal"). We support the SEC's effort to amend the auditor independence rules to refocus the scope of the provisions of Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Provision") and the related analysis required to determine whether an auditor is independent when a lending relationship exists with certain shareholders of an audit client. In doing so, we believe that the Commission is reducing the burden and costs of compliance to issuers and shareholders while enhancing the provisions that safeguard the objectivity and impartiality of the auditor.

Our observations and recommendations with respect to the proposal are organized into the following topical areas in the Appendix, and are based on our experiences in complying with the requirements of the current Loan Provision as well as other provisions of the Commission's auditor independence rules:

I. PwC's proposed application of the Loan Provision to the audit client and its affiliates
II. Specific comments on the Commission's proposal
   A. Beneficial ownership
   B. Significant influence
   C. Known through reasonable inquiry
   D. Exclusion of other fund affiliates
   E. Materiality
   F. Accounting firms' "covered persons" and immediate family members
   G. Evaluation of compliance
   H. Secondary market purchases
   I. Other changes to the Commission's auditor independence rules
   J. Unintended impact of the proposal on other professional standards

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the SEC staff or the Commission may have. Please contact Samuel L. Burke at [redacted] if we can provide you with any additional information or assistance regarding our observations and recommendations included in this letter.

Sincerely,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

APPENDIX

I. PwC's proposed application of the Loan Provision to the audit client and its affiliates

We support the Commission's efforts to ensure that the Loan Provision functions in the manner in which it was originally intended, as well as the objective of increasing the effectiveness of the rule without compromising auditor objectivity and impartiality.

We recognize that the Commission's proposal mitigates a number of significant operational challenges and conceptual inconsistencies in the existing Loan Provision. We are also of the view that the Commission can more fully achieve its stated objectives by implementing our suggested changes. Specifically, we propose that the Commission consider whether the Loan Provision should be limited to debtor-creditor relationships with the audit client and its affiliates only -- and not extend to *non-affiliate lenders that invest in* the audit client. For example, we suggest that a lending relationship with an audit client or a sister-entity affiliate of an audit client continue to be prohibited, but a lending relationship with a non-affiliate investor in that audit client or sister-entity should be permissible. In taking this approach, the Commission's rules would not, in effect, extend the existing considerations of "affiliate" solely for purposes of the Loan Provision, but rather, this proposed approach would maintain consistency with respect to independence considerations concerning entities that are related to the audit client. We believe that following this approach is conceptually supportable and would not compromise auditor objectivity and impartiality. At the same time, it would eliminate the costly and time-consuming operational hurdles that clients and their auditors currently face in complying with the Loan Provision.

The current "affiliate" definition effectively captures entities that would implicate concerns that the Loan Provision was intended to address

We believe that the definition of affiliate currently included in Rule 2-01 of Regulation S-X already captures the entities that would implicate the concerns that the Loan Provision was intended to address. The underlying assumption in the Commission's application of its independence rules to "affiliates of the audit client" is that such entities have a special relationship with the audit client; as a result, having interests in and relationships with affiliates present similar independence concerns as having interests in and relationships with the audit client itself.

Limiting the scope of entities to "affiliates" avoids hardship and overreach concerns and maintains consistency within the Commission's independence rules

As described in Section II(B) of this Appendix, limiting the scope of entities implicated by the Loan Provision to "affiliates" would help to eliminate the hardship and overreach concerns that the Commission considered in adopting the definition of "affiliate." This would also result in greater consistency within the Commission's independence rules. As proposed, the Loan Provision retains an incongruity within the rules, whereby certain interests and relationships (e.g., direct investments) and certain non-audit services would be permitted with respect to non-affiliate lenders that invest in the audit client (and not permitted with respect to affiliates), while lending relationships with these entities would not be permitted. Accordingly, the Loan Provision implies a unique independence concern that lending relationships with certain entities that are not already "affiliates" of the audit client would impair the auditor's objectivity and impartiality. However, the basis for such a concern is not apparent. An approach whereby all of the Commission's independence rules apply equally with respect to the audit client and its affiliates, as opposed to an approach whereby some rules apply with respect to the audit client and its affiliates and other rules apply with respect to a differently-defined set of entities, would provide clarity and consistency in the application of the rules for audit clients and auditors, and make the rules easier to understanding for the reasonable third-party investor.

II. Specific comments on the Commission's proposal

If the Commission decides against the affiliate approach suggested in Section I, we submit the following comments for consideration. If, however, the Commission adopts the affiliate approach, the Commission may nonetheless wish to consider whether any of the following comments may help enhance the Loan Provision, as well as other aspects of its independence rules.

A. Beneficial ownership

We agree with the Commission's proposal to remove the record owner requirement in the Loan Provision. Record owners who hold an audit client's equity securities on behalf of their beneficial owners generally have neither the ability to influence the audit client nor the economic incentive to do so. Accordingly, limiting the evaluation required by the Loan Provision to beneficial owners would, in our view, more effectively capture debtor-creditor relationships that may impair an auditor's independence by identifying shareholders with a special and influential role with the audit client. At the same time, we believe that this element of the proposal will help to ease the significant compliance challenges that exist under the current rule, without raising concerns about potential adverse effects on an auditor's objectivity and impartiality.

The Commission acknowledges in the proposal that, "[i]t has become clear that there are certain fact patterns where an auditor's objectivity and impartiality is not impaired despite a failure to comply with the requirements of the Loan Provision." We agree with this view, and believe that a lending relationship between an auditor and a beneficial owner without an economic interest in the audit client constitutes such a fact pattern. This type of lending relationship would not pose the threats that the Loan Provision intends to address because, despite a significant influence relationship, a beneficial owner without an economic interest is unlikely to seek to influence the audit for its own purposes.

To this end, we recommend that the Commission define the term "beneficial owner," either by way of a cross-reference to the existing securities laws or via inclusion of an explicit definition in Rule 2-01, with a modification that a "beneficial owner" for purposes of the Loan Provision only refers to the person or entity with an economic interest in the shares/profit of the audit client itself. For example, in the case of a trustee with the ability to vote or dispose of the shares of the audit client held solely on behalf of its clients, the trustee would not be considered the beneficial owner of such shares. We believe it is critical that this modification be included, given the reality that many lending institutions hold investments in audit clients as trustee for their clients. Trustee arrangements typically give the lender power to vote the shares and to make decisions to dispose of them, thereby invoking the existing US securities law definition of "beneficial owner," even though the trustee is not the economic owner.

In addition, the Commission should include in the adopting release whether, for purposes of the Loan Provision, the relevant shareholders would include those who control the beneficial owner of the audit client and exclude entities that are under common control with or controlled by the beneficial owner (as indicated in footnote 22 of the proposing release[1]).

B. Significant influence test

We agree with the SEC's rationale in replacing the existing 10% "bright-line" threshold with a significant influence test, as the latter provides a more effective means of identifying those shareholders who have a special and influential role with the audit client and with whom a debtor-creditor relationship may appear to impair an auditor's independence. However, as discussed in greater detail in Section II(E), we believe that the significant influence test would be more effective if it were coupled with a materiality qualifier, in a manner similar to the construct of certain elements of the Commission's current "affiliate" definition.

The proposed Loan Provision includes within its scope the owner of any affiliates of an audit client (except for fund affiliates of fund audit clients). We propose that the standard for a relevant "owner" for purposes of the Loan Provision be whether that entity "would be considered to be in a position to influence the policies and management of the client."[2] There does not appear to be a basis for extending the Loan Provision to owners of affiliates of *any* audit clients (not just fund affiliates of fund audit clients), *unless* the owner of an affiliate is in a position to influence the policies and management of the audit client (i.e., the audited entity) itself. This is consistent with the SEC's approach set forth in

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[1] Auditor Independence with Respect to Certain Loans or Debtor - Creditor Relationships, Securities Act Rel. No. 10491 (May 2, 2018). https://www.sec.gov/rules/proposed/2018/33-10491.pdf

[2] Revision of the Commission's Auditor Independence Requirements, Securities Act Rel. No. 7919 (Nov. 21, 2000). https://www.sec.gov/rules/final/33-7919.htm

Release No. 33-7919, which focuses on shareholders that have a "special and influential role with the issuer" and that "would be considered to be in a position to influence the policies and management of that client." This approach is also consistent with one of the bases for the Commission's fund affiliate exception, which states that "investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex."

The inclusion of investors in affiliates of audit clients (other than fund affiliates of fund audit clients) within the scope of the Loan Provision is contrary to the principles articulated by the Commission when it adopted its definition of "affiliate of the audit client" in 2000. In adopting that definition, the Commission acknowledged in Release No. 33-7919[3] that it would be "overbroad" and would constitute a "hardship" to extend the scope of affiliates of the audit client to any entity that can exercise significant influence in the audit client without also taking into consideration the materiality of the entity's investment in the audit client.[4] However, as proposed, the Loan Provision would be even broader and create a greater hardship by scoping in entities that exercise significant influence over *affiliates* of the audit client but that cannot exert significant influence over the audit client itself.

The application of the Loan Provision to shareholders who do not have the ability to exert significant influence over the entity being audited introduces a substantial burden on entities with respect to the identification of shareholders of affiliates. In the absence of the Loan Provision, these entities would not have to obtain, and likely do not currently obtain, information regarding other shareholders in affiliates that cannot exercise significant influence over the entities being audited, either for the purpose of identification of affiliates or for other purposes. The challenges in obtaining such information, including the identities of the entities controlling those shareholders, could be substantial and entail considerable cost to the entities being audited. In some cases, the information may not even be available to the entity being audited. Entities with large numbers of non-wholly owned affiliates are likely to experience significant difficulties in obtaining the information needed for compliance with the Loan Provision. Therefore, we recommend that the scope of the Loan Provision be limited to only those entities that can exercise significant influence over the audit client itself. If instead the revised Loan Provision is adopted as proposed, we recommend that it include a transition period to allow a reasonable time frame for this information to be gathered and for related processes to be instituted.

We agree with the Commission's position that, for purposes of the Loan Provision, although ASC 323, *Investments — Equity Method and Joint Ventures,* is generally appropriate for independence considerations relating to operating companies, it may not be appropriate in a fund environment. Therefore, we suggest that the Commission make clear in the adopting release that, in determining whether significant influence exists over a fund, it would be appropriate to consider relevant information, which may include, depending on the circumstances:

- Governance structure
- The manner in which shares are held or distributed
- Any contractual arrangements
- Advisory agreement
- Public filings, such as Schedules 13-G and 13-D
- Inquiries of the audit client's management

[3] Ibid.

[4] In response to stakeholder comments that the originally proposed affiliate definition was overly broad and would require the auditor to maintain independence from entities far removed from the audit client, the Commission adopted an approach whereby control relationships between an entity and the audit client, significant influence relationships between an entity and the audit client that are material to the investor, and entities within an investment company complex would constitute the proper threshold for audit client affiliation. This avoided "undue hardships to accounting firms in situations where their audit clients have numerous affiliates that are immaterial to them" (revision of the Commission's Auditor Independence Requirements, Securities Act Rel. No. 7919 (Nov. 21, 2000)).

We suggest that share ownership of a fund does not automatically provide a shareholder with a special and influential role with respect to the fund audit client. For open-end funds, examples of shareholders attempting to influence funds (e.g., proxy contests) are extremely rare.

With respect to private funds and consideration of a shareholder's participation on a board or an advisory committee, we recommend that the role of the board or advisory committee within the fund's governance structure and its operation be assessed to evaluate whether it can exercise significant influence. In situations when the board or advisory committee has substantive oversight responsibility or decision-making capacity over operating and financial policies significant to the fund, we would likely view a shareholder on the board or advisory committee as having significant influence; in the absence of those characteristics, we would likely not consider a member of the board or advisory committee to have significant influence. With respect to private funds and consideration of "kick-out rights," we generally regard kick-out rights with cause as protective in nature, and not as providing shareholders with significant influence.

With respect to exchange-traded funds (ETFs), the Commission notes in the proposing release that, "[i]n circumstances where the terms of the advisory agreement grant the adviser significant discretion with respect to the fund's portfolio management processes and the shareholder does not have the ability to influence those portfolio management processes, significant influence generally would not exist…" We agree with that observation and believe it would be particularly relevant with respect to ETFs, based on their nature, especially index-based ETFs. With respect to Authorized Participants (APs), we also agree that "the deposit or receipt of basket assets by an AP that is also a lender to the auditor alone would not constitute significant influence over an ETF audit client."[5] We understand that ETFs often have contractual arrangements with APs that call for the APs to cede voting rights for the shares they own to another party who "mirror votes" such shares. With respect to market makers, the nature of market-making activities would appear to be dependent on investor demand and activity and not on any special interaction with the ETFs. For these reasons, and in view of the factors typically present in the exemptive orders for ETFs, we generally do not view a shareholder's status as an AP or a market maker as having a significant impact on the assessment of that shareholder's ability to exert significant influence over the ETF.

C. Known through reasonable inquiry

We support the Commission's proposal to add a "known through reasonable inquiry" threshold to the Loan Provision, which would provide that an auditor's objectivity and impartiality (and therefore auditor independence) would not be considered impaired if, after such reasonable inquiry, the auditor is unaware that a lender is also a beneficial owner of an audit client's equity securities. Introducing this concept would help to ease the challenges associated with the Loan Provision, without raising any concerns relating to auditor independence.

The SEC notes in the proposal that the "known through reasonable inquiry" standard is generally consistent with existing regulations in place with respect to the Investment Company Act of 1940 and the Securities Exchange Act, and therefore should be a familiar concept. If the Loan Provision is adopted as proposed, we believe a "top-down" analysis of the potential for significant influence would be appropriate. That evaluation would include consideration of whether a fund's structure could provide an investor with significant influence. The analysis could include, among other criteria, an assessment of governing documents and known relationships disclosed, inquiries of the audit client's management, and reviews of public filings. With this information, an analysis of the holdings of any parties identified as potentially having significant influence could then be undertaken.

We ask that the Commission consider including in the adopting release a statement that, in conducting a reasonable inquiry, an audit client may consider a shareholder not to be a beneficial owner for the purposes of the Loan Provision when that shareholder has taken steps "…to limit its discretion to vote its shares (*e.g.*, the authorized participant has agreed to mirror vote the shares (*i.e.,* vote the shares

[5] Auditor Independence with Respect to Certain Loans or Debtor - Creditor Relationships, Securities Act Rel. No. 10491 (May 2, 2018). https://www.sec.gov/rules/proposed/2018/33-10491.pdf

held by it in the same proportion as the vote of all other shareholders), pass through the vote to an unaffiliated third-party entity, or has otherwise relinquished its right to vote such shares). There also may be circumstances where an institution with a lending relationship with an Audit Firm beneficially owns more than ten percent of the shares of an entity (*e.g.,* a closed-end fund) and has similarly undertaken steps to limit the institution's discretion to vote these shares (*e.g.*, shares are held in an irrevocable voting trust without discretion for the institution as to the voting of shares, the institution has agreed to mirror vote the shares, the institution has agreed to pass through the vote to unaffiliated third-party entity, or the institution has otherwise relinquished its right to vote such shares.)"[6]

We also ask that the Commission include in the adopting release a statement that an audit client may rely on communications with, and public securities filings by, shareholders in which the shareholder indicates that they do not intend to exercise significant influence with respect to the audit client. In these cases, the audit client would not treat such shareholders as having significant influence. These communications could include "negative consent" letters mailed to certain identified owners that may have beneficial ownership of an audit client informing them that the audit client will assume that they will not exercise significant influence unless the audit client receives a written response indicating otherwise.[7] They could also include the shareholders' filings of Schedule 13-G in which the shareholders assert that their holdings were acquired and are held in the ordinary course of business and were not acquired and are not held (1) for the purpose of or with the effect of changing or influencing the control of the issuer of the securities, or (2) in connection with or as a participant in any transaction having that purpose or effect.

Also, we note that, currently, filings on Schedule 13-D are not required for all issuers. The lack of a requirement to disclose investments for other than passive purposes places significant additional burden on issuers to identify shareholders that may be subject to the Loan Provision. If certain shareholders truly hold a "special and influential role" with the issuer, such that loans from those shareholders to the auditor should not be permitted, it is unclear why those shareholders are not required to disclose to investors and regulators their holdings and their role with the issuer.

D. Exclusion of other fund affiliates

We support the Commission's proposal to modify its definition of "audit client" in the fund environment to exclude, for purposes of the Loan Provision, other funds that otherwise would be considered affiliates. This element of the proposal would do much to limit the operational challenges associated with the current rule.

The proposal acknowledges that the broad definition of the term "audit client" in Rule 2-01 of Regulation S-X "gives rise to results that are out of step with the purpose of the rule and ... can have adverse effects when applied in the specific context of the Loan Provision" since the Loan Provision applies to the audited entity as well as all "affiliated" entities. We agree with the investment company complex (ICC) examples presented and support excluding fund affiliates from the definition of "audit client" as it relates to the Loan Provision as this element of the amendments would significantly limit the operational challenges.

However, as described in Section II(B), we believe there is a basis for expanding the scope of this exception to affiliates of *all* audit clients (i.e., not limited to fund environments), *unless* the owner of an affiliate is in a position to influence the policies and management of the audit client (i.e., the audited entity) itself.

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[6] Fidelity Management & Research Company et al., SEC Staff No-Action Letter (June 20, 2016), available at https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm.

[7] See Investment Company Institute (ICI) Memorandum No. 30258 (September 23, 2016), available at https://www.ici.org/my_ici/memorandum/memo30258.

E. Materiality

The Commission is soliciting views relating to materiality considerations for purposes of the Loan Provision. For example, the Commission has asked whether an auditor's independence should only be considered impaired as a result of certain relationships with a beneficial owner of an audit client's equity securities that has significant influence *and* when that investment is material to the lender.

We support incorporating a materiality qualifier in the Loan Provision as it relates both to the lender's investment in the audit client and to the loan's significance to the auditor.

As explained in the proposal, revising the Loan Provision to "…focus only on the beneficial ownership of the audit client's equity securities would more effectively identify shareholders 'having a special and influential role with the issuer.'" We believe that coupling the significant influence test with a materiality qualifier would more effectively identify those that may truly affect the perception of an auditor's objectivity and impartiality given that the lender can not only exercise significant influence over the audit client but also has, on the basis of materiality, the "economic incentive" to do so (a concept that is discussed in the proposal). A lender's investment that is not material would not raise the same concerns with respect to auditor independence.

Further, including a materiality qualifier would more closely align the Loan Provision with the Commission's current definition of "affiliate of the audit client" (which requires that these two concepts be considered in tandem) while its absence would create an inconsistency within Rule 2-01. If an investment is not material to the lender, it would seem highly unlikely that the lender would seek to inappropriately influence the auditor (and, in so doing, incur liability for possible violations of law). Therefore, investments that are not material to the lender do not, in our view, pose the level of concern that the Loan Provision intends to address.

We also recommend adding a materiality qualifier with respect to the significance of the loan to the auditor as this would limit the necessary evaluations to those lending relationships that have the potential to impact auditor objectivity and impartiality. If the loan is quantitatively and qualitatively insignificant to the auditor, there is no reason why the loan should afford the lender the potential to influence the audit, even in the rare circumstance when the lender might be economically motivated to do so. Moreover, this is consistent with other features of the auditor independence rules, such as the "financial relationships" and "business relationships" tests, which prohibit direct or "material indirect" financial and/or business relationships with audit clients.

Given that a loan relationship with an unaffiliated shareholder is not a financial interest in, or other financial arrangement with, the audit client, it is indirect in nature. As a result, a materiality qualifier would be consistent with the provisions of Rule 2-01 with respect to investments that do not represent a direct interest in the audit client (for example, Rule 2-01(c)(1), which prohibits an auditor from having a direct financial interest or a <u>material</u> indirect financial interest in the audit client, and Rule 2-01(c)(1)(i)(E)(2), which prohibits the auditor from having a <u>material</u> interest in an entity over which the client has the significant influence).

The Commission has asked whether a materiality assessment would add unnecessary complexity to the significant influence analysis. We do not believe that it would, as a materiality assessment is already required pursuant to the existing affiliate definition (non-ICC). Rather, it would help the auditor focus on the relationships that implicate the concerns the Loan Provision is intended to address, thus decreasing the compliance burden without compromising an auditor's objectivity and impartiality.

F. Accounting firms' "covered persons" and immediate family members

The Commission has asked if it should amend its definition of "covered persons" - and the application of "immediate family member" (IFM) to that definition - for purposes of the Loan Provision (as well as elsewhere in its independence rules).

We believe that it is appropriate to narrow the scope of these definitions with respect to IFM given that:

1. the level of threats to independence is lower with respect to lenders/shareholders than it is for affiliates (i.e., given the proposed construct, significant influence lenders, without applying a materiality qualifier, would not meet the definition of an affiliate of the audit client), and

2. there is precedent in Rule 2-01 for establishing exemptions for IFMs in certain circumstances, such as with respect to employee compensation and benefit plans.

We would also support removing or revising the prong of the "covered person" definition that includes any partner, principal, or shareholder from the "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit. Furthermore, we suggest that the Commission consider the extent to which such modifications might also be applied beyond the Loan Provision to other areas of the independence rules.

We also recommend that the SEC consider expanding the exemption of certain loans from the Loan Provision. For example, we believe that a lender's ability to influence the auditor through a lending relationship would be present only at the loan's origination, modification, or delinquency. Loans with terms that cannot be changed unilaterally by the lender are unlikely to impact an auditor's independence. Accordingly, we support exemptions for such loans obtained prior to a partner or staff member becoming a covered person. Loans with these characteristics would not threaten an auditor's independence, either in appearance or in fact.

The proposed Loan Provision would likely implicate a different population of shareholders than is implicated by the current Loan Provision. Accordingly, we request that the SEC consider providing a reasonable transition period for covered persons to comply with the requirements of the amended Loan Provision.

G. Evaluation of compliance

The Commission has asked if auditor independence may be assessed in reliance on disclosures relating to beneficial owners as of a specified date (e.g., Item 18 of Form N-1A and Item 19 of Form N-2). We believe that registrants and auditors should be able to rely on public information, as explained in Section II(C) above.

In addition, the Commission has posed a question as to whether the Loan Provision, or other financial relationships, should be assessed at specific dates during the audit and professional engagement period, or the beginning or ends of specific periods, or under specified circumstances. With respect to funds, we agree that if the auditor determines that significant influence over a fund's management processes could not exist, then the auditor could monitor its independence by re-evaluating the initial determination in response to a material change in the fund's governance structure or governing documents, and reviewing publicly available information about beneficial owners or other information the audit client or auditor become aware of that may impact the ability of a beneficial owner to exert significant influence. With respect to other entities, we believe that the frequency and timing of the evaluation should be developed based on an assessment of the particular considerations relevant to each audit client.

H. Secondary market purchases

The Commission has asked for views as to the treatment of secondary market relationships (e.g., promissory notes sold on the secondary market to new purchasers thereby creating new lending relationships between an audit firm and the new purchasers). We believe that such situations could be addressed by the introduction of grandfathering provisions, mirroring those that currently exist in the Loan Provision.

In addition, as described above under Section II(F), we recommend a broad grandfathering provision that would apply to all loans with terms that cannot be changed unilaterally by the lender that originated (1) in the case of the audit firm, prior to the firm accepting appointment to serve as auditor,

(2) in the case of the individual, prior to the assignment of covered persons to the audit engagement, or (3) prior to the shareholder acquiring the ability to exert significant influence. When the terms of such loans cannot be changed unilaterally by the lender, they do not interpose a point of leverage between the lender and auditor, and thus do not pose a threat to objectivity or impartiality.

I. Other changes to the Commission's auditor independence rules

The SEC has asked whether other changes, beyond those relating to the Loan Provision, should be made to its auditor independence rules. We believe that it is appropriate to consider potential enhancements to the SEC's independence rules given the length of time that has passed since the last significant revisions were made, the changes that have occurred in the marketplace over that period, and the dramatic changes brought about by technological advances.[8] As such, we would welcome further dialogue on this topic and, in the interim, offer a few recommendations on potential areas of reconsideration.

1. Definition of affiliate of the audit client

   As the Commission notes in the proposal –

   > "... another practical challenge is that the auditor independence rules' broad definition of the term "audit client" gives rise to results that are out of step with the purpose of the rule and that can have adverse effects when applied in the specific context of the Loan Provision."

   We believe that these very valid concerns with respect to the Loan Provision apply equally to other areas of the independence rules, in particular with respect to the expansive scope of the definition of "investment company complex," as well as common control entity situations relating to non-fund affiliates. We suggest that the Commission reconsider the "affiliate" definition, for example, by narrowing the scope of the ICC definition and applying a materiality threshold to entities under common control (consistent with both domestic and international auditor independence rules). Such changes would result in lower costs and improved operational efficiencies without having a negative impact on auditor objectivity and impartiality.

2. Materiality considerations

   While we acknowledge the Commission's responsibilities pursuant to the Sarbanes-Oxley Act to issue regulations that align with the auditor independence requirements as set forth in the Securities Exchange Act of 1934, we believe that the Commission should give consideration as to how the concept of materiality can be given greater prominence in the Commission's independence rules, in a manner consistent with how this principle is applied in the accounting and auditing literature. Doing so would help to avoid situations, as the SEC points out in this proposal, where –

   > "... auditors and audit committees may feel obligated to devote substantial resources to evaluating potential instances of noncompliance ... which could distract auditors' and audit committees' attention from matters that may be more likely to bear on the auditor's objectivity and impartiality."

   For example, the Commission could consider expanding the existing "safe harbor" provision in Rule 2-01(d) to include other areas of its independence rules, as appropriate, to avoid unnecessary consideration of matters that are clearly de minimis.

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[8] As part of any effort to reconsider its auditor independence rules, the Commission may also wish to revisit the recommendation on page VII:18 in the [Final Report of the U.S. Treasury Department's Advisory Committee on the Auditing Profession](), to "...compile the SEC and PCAOB independence requirements into a single document and make this document website accessible." In doing so, the SEC could, at the same time, resolve any existing conflicting or unclear guidance that exists between, and perhaps within, these two rule sets, in particular with respect to the PCAOB's Interim Standards. We note that several domestic and international standard setters have undertaken "codification efforts" to great effect.

3. Business relationships

We suggest that the Commission revisit the business relationship rules in light of the difficulty in applying them and in response to changes in the business environment since the rule was developed. In today's dynamic business environment, to enable the auditor to perform the ongoing monitoring necessary to maintain independence, clarity regarding the shareholders that would be implicated by the business relationships rule is critical. Therefore, we recommend that the rule be revised to align with the proposed Loan Provision by implementing a significant influence test in place of the current substantial stockholder in a decision-making capacity test.

Auditors are familiar with the significant influence test and would be able to more consistently apply it than the current standard. Additionally, as with the Loan Provision, the significant influence test appropriately addresses the potential threats to independence. This would result in consistency in the population of non-affiliate shareholders who would be subject to the Loan Provision and the business relationship restrictions, and would therefore impose less of a burden on audit clients and auditors in complying with these rules. As we have proposed with respect to the Loan Provision, we ask that the Commission clarify that the business relationship rule applies only to those shareholders who are able to exert significant influence over the audit client itself.

4. Control

We suggest that the Commission give further consideration to the manner in which the term "control" is applied in the context of the definition of an "affiliate of the audit client." There are concepts in the definition of control (as used in the accounting literature) that might improve the application of the current definition used for the identification of affiliates. We suggest that the Commission consider whether the current definition could be improved by incorporating those concepts.

5. Mergers and acquisitions, initial public offerings

Given the prevalence of initial public offerings (IPOs) and mergers and acquisitions in the current business environment, we recommend that the Commission consider the impact of these transactions on the ability of the auditor to comply with the relevant independence requirements.

We encourage the Commission to consider potential enhancements to its independence rules relating to inadvertent violations that arise in situations when an audit client is involved in a merger or acquisition that, for example, is consummated during the professional engagement period. In such circumstances, a new affiliate relationship may be created and therefore certain relationships between the auditor and that entity will become subject to the SEC's independence rules - prospectively and possibly retrospectively - resulting in possible impairments of independence. The Commission may wish to consider whether it is appropriate to allow for a reasonable period of time subsequent to a transaction's closing during which any relationships that are inconsistent with the independence rules would not be considered to impair independence provided that they are restructured or terminated, as appropriate, in a timely fashion.

Likewise, a company preparing for an IPO in the United States is required to be audited for the two- or three-year period before its IPO filing. Therefore, a potential filer will need to plan well in advance in order to ensure that, among other matters, its auditor is independent under SEC rules covering that period of time (i.e., the audit period). Under current requirements, an auditor that has complied with another independence rule set, such as that established by the American Institute of Certified Public Accountants, may not be deemed to have satisfied the Commission's independence requirements in this circumstance. This results in potentially costly and burdensome outcomes, such as the potential need for the IPO filer to engage a new auditor (e.g., for the purpose of undertaking a re-audit). As such, the Commission may wish to consider whether an appropriate solution for such situations may be developed, such as extending the definition of the "audit and professional engagement period," as it currently applies to certain foreign private issuers, to include domestic IPO filers as well. Doing so would allow more time for auditors and filers to transition to SEC independence requirements.

6. Broader application of certain Loan Provision proposals

   We agree that several areas of the proposal offer valuable enhancements to the application of the Loan Provision. These include the "known through reasonable inquiry" threshold, the exclusion of certain fund affiliates from the definition of an audit client, and the narrowing of the application of the covered person and immediate family member definitions. Given their value in this context, the Commission may wish to consider whether the benefits of these proposed enhancements may be more broadly applied to other areas of its independence rules. For example, the "known through reasonable inquiry" threshold could be considered with respect to situations that arise relating to private equity investment funds and business relationships, when information regarding upstream or downstream entities may be unavailable due to regulation, confidentiality provisions, or for other reasons.

J. Unintended impact of the proposal on other professional standards

The Commission has asked whether the proposal may have an unintended impact on other professional standards. We believe that there are certain elements of the proposed amendments to the Loan Provision that would be in conflict with other professional standards and, as a result, could lead to confusion and possible unintended consequences. For example, the proposal conflicts with Rule 101 of the PCAOB Interim Independence Standards, which limits the application of the prohibition on loans to lending relationships with individuals, *not entities*, that are "10%" owners, providing, in part, that:

> "Except as specifically permitted in interpretation 101-5 [ET section 101.07], had any loan to or from the client, any officer or director of the client, or **any individual owning** 10 percent or more of the client's outstanding equity securities or other ownership interests" (emphasis added)

Likewise, this conflict exists with respect to the AICPA *Code of Professional Conduct's* "Loans" interpretation (AICPA Professional Standards, ET 1.260.010), which reads similarly, as well as the numerous state CPA societies and Boards of Accountancy that adopt the AICPA *Code of Professional Conduct*. Accordingly, we suggest that the Commission consider these differences along with their potential impact and, at a minimum, consider modifying the PCAOB Interim Independence Standards to conform to the final rule ultimately adopted.

The Commission may also wish to consider whether the "individual vs. entity" principle embodied in the AICPA and PCAOB Interim Standards is an appropriate interpretation of its own Loan Provision. We note that adopting this principle (i.e., limiting the Loan Provision to certain *individual* investors in the audit client) would eliminate many, if not all, of the operational complexities associated with applying this provision to *entities* that are related to the audit client. At the same time, adopting this principle will foster consistency between the two rule sets without adversely affecting auditor objectivity and impartiality.