July 3, 2018

By email: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-10-18: Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships; Release Nos. 33-10491; 34-83157; IC-33091; IA-4904.

Dear Office of the Secretary:

The Center for Audit Quality ("CAQ") is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors’ objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs ("AICPA"). This letter represents the observations of the CAQ but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the opportunity to share our views and provide input on the Securities and Exchange Commission’s ("Commission" or "SEC") Proposed Rule, Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationship ("Proposed Rule" or "proposal"). The CAQ firmly believes that the Commission’s auditor independence requirements play an important role in helping to protect the reliability and integrity of financial statements issued by registrants. We are committed to helping ensure that modifications to the Commission’s auditor independence requirements are designed to continue enhancing investor protection.

The CAQ shares the Commission’s goal of improving certain aspects of Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the “Loan Provision”) that do not serve
investors’ interests and the capital markets, or are otherwise not working as intended. We support the Commission’s thoughtful proposal of revisions that would increase the effectiveness of the Loan Provision without jeopardizing auditor objectivity and impartiality in the performance of an audit. In this letter, we outline some of the practical challenges confronted in addressing the current Loan Provision, provide detail regarding our support for the specific elements of the Proposed Rule, and offer a few additional considerations in response to questions posed by the Commission in its proposal.

I. Challenges Presented by Existing Loan Provision

We concur with the Commission’s view that the existing Loan Provision “may not be functioning as it was intended,” and support the proposal to modify the rule, as discussed further below.¹

As conceived, the Loan Provision was designed to curb potential self-interests arising from a debtor-creditor relationship that could compete with an auditor’s obligation to perform an audit with objectivity and impartiality. We agree with the Commission that the independence requirements should address this concern not only with respect to lending relationships between the accounting firm and the audited entity, but also with respect to shareholders of the audited entity who have a “special and influential role” with the audited entity.²

However, the current Loan Provision as applied to certain situations can result in non-compliance with the rule even though there is plainly no impact on the auditor’s objectivity and impartiality. The proposal accurately portrays a number of facts and circumstances that give rise to the challenges SEC registrants and accounting firms confront in applying the existing Loan Provision.³ For example, as a result of the 10% threshold and the “record” owner requirement in the existing Loan Provision, numerous financial intermediaries – such as custodians and broker-dealers – that operate as “record” owners for the benefit of their customers may be scoped into the rule, and independence issues can arise if such financial intermediaries also are lenders to (or are affiliated with lenders to) an accounting firm or covered persons in an accounting firm. These financial intermediaries generally are not “beneficial owners” and have neither the ability nor the economic incentive to influence the audited entity through the holdings for which they are shown as the “record” owner. While some of the challenges are particularly prevalent in the investment company complex (“ICC”) arena, the issues associated with the current Loan Provision requirements are not limited to these types of clients: practical challenges in applying the existing Loan Provision also can arise, for example, with respect to operating companies.

The costs and burdens in applying the current Loan Provision are not insignificant for registrants or accounting firms, and as noted in the proposal, some of these costs ultimately are borne by

shareholders.\textsuperscript{4} Accounting firms have financing needs from time to time, and may engage in lending activity with commercial banks or other financial institutions – in the form of various borrowings as well as private placement debt issuances – to fund both current operations and investments. The creditors involved in these lending relationships often represent a diverse group of financial institutions. Substantial resources are devoted to monitoring these relationships and investments in audited entities made by these lenders, even though in many circumstances no reasonable investor would perceive any adverse impact on the auditor’s objectivity or impartiality as a result of the lending relationships. The fact that registrants and accounting firms must incur these substantial costs and burdens in applying the existing Loan Provision to relationships in which “no reasonable person would view [the circumstances] as implicating an auditor’s objectivity and impartiality” underscores the need to perform maintenance on the rule.\textsuperscript{5} In our view, the revisions to the Loan Provision outlined in the proposal would better serve investors by focusing the time and resources of registrants and accounting firms on other matters.

II. Proposed Amendments to the Loan Provision

Removing “Record” Owners from the Loan Provision

We support the Commission’s proposal to remove the reference to “record” owners from the Loan Provision. As the Commission notes, record owners generally lack the ability and the incentive to exert influence over the audited entity.\textsuperscript{6} Thus, a lending relationship between an accounting firm and a party that also happens to be a record owner with respect to an investment in an audited entity presents no actual or potential threat to the ability of the accounting firm to perform an audit with objectivity and impartiality. Focusing on beneficial ownership better serves to identify possible relationships where a shareholder (that is also a lender) might have a special and influential role with the audited entity and thus better aligns with the underlying purpose sought to be achieved by the Loan Provision.

In finalizing the amended rule, we encourage the Commission to clarify the meaning of beneficial owner in the context of the Loan Provision. We acknowledge that the beneficial owner concept is separately defined in the securities laws – see Rule 13d-3 of the Securities and Exchange Act of 1934 – but we believe that a narrowed definition for beneficial owner would be appropriate for the Loan Provision. In the context of this provision, we believe that beneficial owners should be defined to include only those that have an economic interest in the audited entity. An owner that lacks an economic interest in the audited entity is unlikely to have an incentive to attempt to influence the auditor’s report.

Separately, we also support the guidance provided in the proposal that the lending relationships implicated by the Loan Provision are those between an auditor and entities that control the beneficial owner of the audited entity, but not lending relationships with entities that are under

\textsuperscript{4} Proposed Rule, page 18.
\textsuperscript{5} Proposed Rule, page 16-17.
\textsuperscript{6} Proposed Rule, page 20.
common control with or controlled by the beneficial owner of the audited entity.\textsuperscript{7} We believe this is helpful guidance, and encourage the Commission to include this the final rule or in the release accompanying the final rule.

\textit{Significant Influence Test}

The Commission’s proposal to replace the 10% ownership threshold with the significant influence test represents an appropriate modification to the Loan Provision that ties closely to the underlying goal of identifying lenders that potentially have a special and influential role over the audited entity. For the reasons identified by the Commission, the 10% rule is both over- and under-inclusive. Some entities with more than 10% ownership may not have the ability to influence the audited entity, and thus a lending relationship between an auditor and such an entity presents no threat to auditor objectivity and impartiality. On the other hand, it is conceivable that an entity with less than a 10% ownership interest may have the ability to exert significant influence over the audited entity, for example, through certain contractual rights.

The significant influence test strikes a better balance between the costs and benefits associated with adopting rules that further investor protection. It captures lenders who have a “special and influential role” over the audited entity – the original rationale for extending the Loan Provision beyond loans that are only between the auditor and the audited entity – while leaving outside the scope of the rule those lending relationships that are unlikely to impact auditor independence. This approach should help in addressing some of the practical challenges that arise in applying the rule. The significant influence test, as the Commission notes, has the further benefit of familiarity. It is a concept that already exists in the Commission’s auditor independence requirements and, as such, is a test that accounting firms and companies can readily apply.\textsuperscript{8} As reflected in the proposal, the significant influence test is rooted in the accounting principle found in FASB Accounting Standards Codification (“ASC”) 323, \textit{Investments – Equity Method and Joint Ventures} (“ASC 323”). As a result, the standard is one that lends itself to application both by accounting firms and registrants.\textsuperscript{9}

Because registrants are generally familiar with the significant influence concept and typically possess the information relevant to applying the concept, we encourage the Commission to provide some guidance when it adopts the revised Loan Provision that underscores the audited entity’s role in applying the significant influence test. The Commission has reiterated that “maintaining independence is a shared responsibility” between the accounting firm and the audited entity.\textsuperscript{10} We agree with this principle and believe it would be helpful to include guidance when adopting the final rule to emphasize for audited entities their responsibilities in applying the significant influence test.

\textsuperscript{7} Proposed Rule, page 10, note 22.
\textsuperscript{8} See, \textit{e.g.}, 17 C.F.R. § 210.2-01(f)(4)(ii) and (iii).
\textsuperscript{9} Proposed Rule, page 24 (“[T]he concept of ‘significant influence’ is one with which audit firms and their clients are already required to be familiar.”).
In this regard, guidance reflecting that registrants should participate by providing information that
the registrant believes is relevant to the significant influence assessment – including identifying
entities that the registrant believes have significant influence over such entity’s decision-making –
would substantially facilitate compliance with the rule. Registrants are generally in the best position
to know which entities, if any, may have significant influence over their decisions, and identifying
such entities for the accounting firm could help bridge information gaps that otherwise might exist
for the firm. The accounting firm then could use the information provided to help in applying the
significant influence test.

While the significant influence test is broadly understood by accountants, the concepts in ASC 323
are not routinely applied in the investment fund context. The Proposed Rule lists several factors
registrants and accounting firms could consider in analyzing the significant influence test for funds.
We agree with the Commission that “the operating and financial policies relevant to the significant
influence test would include the fund’s investment policies and day-to-day portfolio management
processes, including those governing the selection, purchase and sale, and valuation of investments,
and the distribution of income and capital gains.”

This information can be gleaned through the governance structure and governing documents, as well as the nature of the services provided by
the investment advisers. We endorse the factors as described above for assessing significant
influence in the fund context. The proposal also suggests that participation rights, such as
participation on a fund advisory committee, would indicate that the shareholder likely has significant
influence. Although we agree that participation rights should be a factor in assessing significant
influence in the fund context, we do not believe that this factor alone is likely to indicate significant
influence. In our view, these types of rights are relatively common in the fund context and are
unlikely to be indicative of a special and influential role over fund portfolio management.

Known through Reasonable Inquiry

The Commission’s proposal to include a “known through reasonable inquiry” standard reflects a
practical approach to applying the rule, particularly given the concerns in this area that have arisen
regarding access to information. We support inclusion of this standard in the final rule. We agree
with the view expressed by the Commission that if an accounting firm, in coordination with the
audited entity, “does not know after reasonable inquiry that one of its lenders is also a beneficial
owner of the audit client’s equity securities, including because that lender invests in the audit client
indirectly through one or more financial intermediaries, the auditor’s objectivity and impartiality is
unlikely to be impacted by its debtor-creditor relationship with the lender.”

The Commission may wish to expand on one aspect of the “reasonable inquiry” standard.
Specifically, the Commission cites certain other provisions of the securities laws where a “reasonable
Because these tests suggest that what constitutes reasonable inquiry in any given situation is largely dependent on the facts and circumstances, it may help to provide some additional parameters as to what the Commission might view as sufficient to constitute reasonable inquiry in the context of the independence rules. We suggest that reasonable inquiry could include review of publicly available information—such as public filings—as well as information available through the client regarding fund governance and structure, and documentation regarding investor rights.

Excluding Other Affiliates

We support the Commission’s proposal to exclude funds that otherwise would be considered an affiliate of the audited entity from the definition of “audit client” for purposes of the Loan Provision. This reflects a reasonable approach for modifying the rule where it is evident that no possible threat to independence was being addressed by retaining such funds within the scope of the rule.

In discussing this element of the proposal, the Commission acknowledges that the “inclusion of certain entities” as a result of the definition of “audit client” is in tension with the original purpose of the Loan Provision. However, the proposal’s exclusion only applies to other funds—not all “entities” in the fund complex—even though the same rationale would apply to other entities. We encourage the Commission to clarify that in the fund context the exclusion applies not only to affiliated funds, but also to all affiliates of the entity under audit. Similarly, as currently drafted the proposal excludes fund affiliates of audited funds without addressing downstream affiliates of the excluded funds. We encourage the Commission to clarify that downstream affiliates of the excluded funds also are outside the scope of the Loan Provision.

Finally, the same principles that underpin the exclusion for funds also can be applied outside the fund context. For example, it is unlikely that an investor with significant influence over an immaterial subsidiary of an issuer that is being audited would have any special or influential role over the issuer. Thus, we encourage the Commission to consider modifying the exclusion for purposes of the Loan Provision, so that it applies to all downstream and commonly-controlled affiliates of any registrant under audit (not only a fund under audit).

III. Additional Considerations

Materiality

In the proposal, the Commission indicates that adding a materiality qualifier to assess the significance of the lender’s investment in the audited entity’s equity securities is unnecessary, but nonetheless seeks views on this issue. If the Commission adopts our recommendation above to clarify the scope of affiliates to be excluded, we agree with the Commission and believe that it is not necessary to add a materiality qualifier to evaluate the lender’s investment in the audited entity’s securities. However,

if these suggestions for clarifying the scope of affiliates that are excluded from the Loan Provision are not incorporated into the final rule, a materiality qualifier for the lender’s investment in the audit client, including affiliates, would be beneficial. Because the definition of “audit client” would include affiliates of the audited entity, the Loan Provision would apply to situations in which a lender has an investment in an affiliate of the audited entity over which it exerts significant influence – regardless of whether that lender has any influence over the audited entity. Such a relationship is unlikely to impact an auditor’s objectivity and impartiality. Including a materiality qualifier would better serve investors by reducing compliance costs while maintaining protections that are designed to promote auditor impartiality.

The Commission should also consider including a materiality qualifier with respect to the auditor’s lending relationship, such that the application of the Loan Provision is only triggered where the lending relationship between the accounting firm and the lender that has significant influence over the audited entity is material, in the aggregate, to the auditor (i.e., the accounting firm or covered person in the accounting firm). Although the accounting firm, in coordination with the audited entity, would still have to expend considerable resources to identify instances where lenders are invested in audited entities and assess whether significant influence is present where such investments exist, we believe that a reasonable investor would still conclude that an auditor’s objectivity and impartiality is not impacted where the lending relationship is not material to the auditor.

Finally, the Commission’s current rule excludes certain loans obtained from a financial institution under its normal lending procedures, terms, and requirements, such as automobile loans and collateralized mortgage loans. We encourage the Commission to consider extending this exclusion to other types of collateralized loans or immaterial loans. Loans secured by property or securities in a brokerage account made under normal lending arrangements that are offered as part of typical lending arrangements to all customers or loans that are immaterial to the covered person’s net worth are unlikely to impair auditor objectivity and impartiality.

**Evaluation of Compliance**

In the proposal, the Commission inquires whether the Loan Provision and other independence provisions involving financial relationships should be assessed at specific dates during the audit and professional engagement period, or at the beginning or ends of specific periods. We believe the Commission does not need to include such a requirement. Because of the practical difficulties in evaluating compliance and the variety of audited entities and types of information available, we believe it would be impractical to establish a specified date or approach at which compliance should be measured. Further, we think it will be beneficial to allow for the particular facts and circumstances relevant to the audited entity to drive the judgments as to when and how compliance is assessed. We nonetheless appreciate the Commission’s suggestion that reevaluation of independence for funds could be triggered in response to a material change in governance structure and governing documents or publicly available information about beneficial owners, and we encourage the

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Commission to provide guidance on factors that it believes may trigger reevaluation when adopting the final rule.18

Other Considerations

The Commission also inquires whether there are other changes to the auditor independence rules that are warranted.19 We appreciate the opportunity to open dialogue with the Commission regarding aspects of the independence rules we believe could be improved. While many aspects of the current independence rules are clear, there are some elements, as with the Loan Provision, that we believe would benefit from maintenance or clarification, particularly as certain aspects of the rules may not reflect significant ways in which businesses and markets have evolved in the past twenty years. Modifications to certain existing rules could help align the overall approach to independence with current business structures, and enhance investor confidence as well as facilitate capital formation, while maintaining independence in fact and appearance. We offer observations in several areas where the existing independence provisions could be modified because such provisions may not be functioning as intended.

Scope and application of the affiliate rule: An example of such an area is with respect to certain aspects of the Commission’s definition of “affiliate of the audit client,” which were not designed to address the increasingly interconnected nature of modern global business. In particular, the first prong of this definition, which includes entities “under common control with the audit client,”20 can present numerous practical challenges for registrants and accounting firms because the rule does not limit the definition of affiliate to those entities that are reasonably likely to pose independence concerns with respect to an audited entity. For example, where a private equity firm has an interest in a portfolio company that is an audited entity and another portfolio company (the “sister company”), both entities generally fall under the definition of “affiliate of the audit client” because the first prong of the definition includes entities “under common control with the audit client.” This provision, commonly referred to as the “up-and-over” provision, sweeps into the definition of “audit client” an audited entity’s sister companies irrespective of the nature of their relationship and without consideration of the materiality of the entities under analysis. This creates independence issues where, for example, an accounting firm has certain types of relationships with an immaterial sister company that is not an audited entity, and that sister company is under common control with the company being audited – even though neither company controls or exerts any influence over the other, and the financial statements of each company are not part of the consolidated financial statements of a common parent. In our view, this relationship typically would present no actual or potential threat to independence, and should have no bearing on the auditor’s objectivity and impartiality. As the Commission observed with the Loan Provision, this is another situation where “the auditor independence rules’ broad definition of the term ‘audit client’ gives rise

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18 Proposed Rule, page 41.
19 Proposed Rule, page 42.
to results that are out of step with the purpose of the rule.”21 We encourage the Commission to consider potential modifications to the “up-and-over” provision in light of these concerns.

Relatedly, we encourage the Commission to consider whether it would be appropriate to clarify the term “control” as used in the “affiliate of the audit client” definition. As highlighted with the use of the significant influence standard in the proposal, the use of accounting concepts in applying elements of the independence requirements has the benefit of familiarity. Accordingly, it may be beneficial to explore how concepts of accounting control could be considered to inform qualitative factors used in applying the term “control” in the “affiliate of the audit client” definition.

In addition, the ICC prong of the “affiliate of the audit client” definition presents challenges in application, even outside the Loan Provision context. The breadth of the provision sweeps in entities in the ICC that are not material. We encourage the Commission to consider potential modifications to this prong, such as providing that investment advisers, general partners, or trustees of the audited entity would only be considered part of the ICC if the audited entity is material to those entities and if they have control or significant influence over the audited entity.

Transition Rules: The Commission’s independence rules currently do not provide for a transition or grace period when a company undertakes an initial public offering (“IPO”) that would allow such company and its auditor to transition from the set of independence rules that governs private company audits to the Commission’s full independence rule set that governs public company audits. As a practical matter, this means that a company preparing for an IPO is required to engage an accounting firm that has been independent under the Commission’s rules for the entirety of the financial statement period included in the registration statement with the Commission – typically a two- or three-year period before the IPO filing in the United States. This approach can require considerable additional expense to the company (either due to additional audit procedures or due to the potential need to engage a different auditor) and can hinder capital growth. The absence of a transition period adds to challenges faced by companies seeking to go public, as they would have to plan for this possibility years in advance in order to meet the existing independence requirements. We note that the Commission’s rules currently provide foreign private issuers some relief from having to comply with the independence requirements for all years included in an initial registration statement.22 In assessing this issue, the Commission may wish to consider extending the relief granted to foreign private issuers to all IPO filers.

Similarly, the rules do not provide for any transition or grace period when a transaction occurs during an audit or professional engagement period, and the closing of the transaction could trigger a violation under the independence rules. For example, this could occur when the audited entity acquires a company to which the accounting firm (or a member of its global network) provides prohibited services that, although permitted prior to the transaction, are prohibited by the SEC’s

22 17 C.F.R. § 210.02-01(f)(5)(iii) (providing that the “audit and professional engagement period” for a foreign private issuer does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed a registration statement or report with the Commission).
independence rules post-transaction. In this scenario, it seems unlikely that a reasonable investor apprised of all relevant facts would think that allowing the accounting firm a reasonable period of time to transition out of the service engagement with the company being acquired would impair the independence of the audit overall. Where any transition period is applied, we would expect that the accounting firm would have to assess the impact of the situation on the firm’s ability to comply with the general standard for independence and would need to disclose the matter and the evaluation of the firm’s independence to the audit committee. We encourage the Commission to consider potential enhancements to the independence rules to address these concerns regarding transition issues.

**Custody Rule Modification:** Rule 206(4)-2 includes several restrictions on the audit provision exception to the custody rule’s surprise inspection requirement.\(^2\) One of those restrictions, current subsection (b)(4)(ii), requires the funds at issue be audited by an independent public accountant that is “registered with, and subject to regular inspection” by the Public Company Accounting Oversight Board (“PCAOB”) “in accordance with its rules.” The SEC rules further specify that the audit has to be performed in accordance with its independence requirements.\(^2\) Although we believe it is appropriate that an accounting firm performing a custody audit should be registered with the PCAOB, these audits are often performed at ICC and other pooled investment vehicle complexes where numerous entities are brought within the “expansive definition of ‘audit client’” as a result of the “affiliate of the audit client” definition, including entities that are not audited by the accounting firm conducting the custody audit.\(^2\) As a result, we encourage the Commission to modify its rule so that, although the accounting firm conducting the custody rule audit has to be registered with the PCAOB and subject to regular inspection, that accounting firm’s independence will be assessed using otherwise applicable independence standards (i.e., the AICPA’s requirements), not the Commission’s independence requirements. This would have the further benefit of aligning the independence standards with the standards by which the audit is conducted, as the fund audits are not performed in accordance with the PCAOB’s standards.

**Expanded Safe Harbor:** The Commission’s rules currently provide a “safe harbor” for situations where the independence of a covered person in the accounting firm is inadvertently impaired, provided that the violation is corrected promptly and the accounting firm maintains an adequate quality-controls system. However, there is no exception for other types of non-compliance with the independence rules where such non-compliance is inadvertent and de minimis. This can lead to unwarranted challenges in situations where, for example, a member firm of an accounting firm’s global network inadvertently violates the independence rules as a result of a limited impermissible relationship with an affiliate of an audited entity, but a reasonable investor would not view those services or relationships as adversely impacting the accounting firm’s objectivity or impartiality. The Commission could consider expanding the existing “safe harbor” provision to also include inadvertent and de minimis violations of other independence rules. Similar to the transition rule, we also would expect that the accounting firm would have to assess the impact of the situation

\(^2\) 17 C.F.R. § 275.206(4)-2.
\(^2\) 17 C.F.R. § 275.206(4)-2(d)(3).
on the accounting firm’s ability to comply with the general standard for independence and would need to disclose the matter and the evaluation of the accounting firm’s independence to the audit committee.

**Business Relationship Rule:** We believe that aspects of the business relationship rule also may be out of step with the Commission’s original intent in adopting this provision. See Rule 2-01(c)(3) of Regulation S-X. First, the independence rules restrict certain business relationships with substantial stockholders that have decision-making capacity over the audited entity. For many of the same reasons articulated in the Proposed Rule, we recommend the Commission replace the substantial stockholder in a decision-making capacity test that currently exists with the significant influence test. The substantial stockholder in a decision-making capacity test is an amorphous concept, and as a result, the phrase may be applied inconsistently. Conversely, the significant influence test is well established and understood, and as with the Loan Provision, using this test instead of the substantial stockholder test would still address actual threats to independence.

Second, technological advances in the past two decades have transformed the manner in which many businesses structure their operations and conduct business. There are numerous practical issues that arise in applying the existing business relationship rule in today’s interconnected, global business environment because the rule has some general concepts that may be susceptible to overly broad interpretations, particularly in view of the complex business structures that exist today. We encourage the Commission to engage in dialogue with relevant stakeholders regarding how these practical issues may be resolved given the current business environment.

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We appreciate the opportunity to comment on the questions raised in the proposal. As the Commission and Staff gather feedback from other interested parties, we would be pleased to discuss our comments or answer any questions that the Commissioners or Staff may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

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