July 3, 2018

Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Via e-mail: rule-comments@sec.gov


Dear Office of the Secretary:

Crowe LLP appreciates the opportunity to provide our input on the Securities and Exchange Commission’s (“Commission” or “SEC”) Proposed Rule, Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships (“Proposed Rule”, “Proposal” or “Loan Provision”).

We commend the Commission’s efforts to evaluate and improve certain provisions of Rule 2-01 of Regulation S-X. In particular, we support the Commission’s proposed amendments to its auditor independence rules related to when the accountant has a lending relationship with certain shareholders of an audit client. We agree that it is important to identify debtor-creditor relationships that could impair an auditor’s objectivity and impartiality, but not include certain lending relationships that are unlikely to present threats to objectivity and impartiality.

We have included our observations on the major provisions of the proposed amendments and our responses to the Commission’s requests for comment.

Proposed Amendments to the Loan Provision

Focus the Analysis Solely on Beneficial Ownership

We support the Commission’s proposed amendment for the Loan Provision to apply only to beneficial owners of the audit entity’s equity securities and not to those who merely maintain the audit entity’s equity securities as a holder of record on behalf of their beneficial owners (i.e. “record owners”). We believe eliminating the requirement to analyze record owners under the Loan Provision will ease the compliance challenges. Record ownership percentages can fluctuate during the audit and engagement period and obtaining this information and monitoring for changes requires significant effort. When an incident of non-compliance occurs, the accountant’s objectivity and impartiality has not been impaired because typically the record owner does not have significant influence.
Significant Influence Test

We agree with the Commission's assessment that the current bright-line 10 percent test may not be properly identifying debtor-creditor relationships that impair the accountant's objectivity and impartiality. If a lender is unable to influence the audited entity through its investment, then the investment would not threaten an accountant's objectivity and impartiality. We agree that only shareholders with a special and influential role should be included in the Loan Provision.

The assessment of identifying shareholders that have a special and influential role with the audited entity requires judgment on the part of accountants and issuers and is particularly challenging to apply in the investment fund context. The industry has historically applied the principles in FASB ASC topic 323, Investments – Equity Method and Joint Ventures; however, the concepts in this standard are not consistently applied in the investment fund context given the unique nature of these structures. We agree that evaluating the governance structure and governance documents are key considerations in determining significant influence, and the SEC's Proposal includes various factors for evaluating these structures and documents. We suggest the SEC include these factors in their final rule in order to provide guidance to accountants and issuers in determining significant influence.

The process for assessing significant influence is a joint effort by accountants and issuers. We believe the issuer is in the best position for identifying entities with significant influence since they have access to documents and information that might not otherwise be available to the accountant. Guidance directing issuers to perform an initial assessment of identifying entities the issuer believes have significant influence and then providing relevant documents to the accountant would be helpful in ensuring the issuer takes primary responsibility for this assessment while supporting the concept of sharing this responsibility with the accountant.

Reasonable Inquiry Compliance Threshold

The inclusion of the “known through reasonable inquiry” provision is a practical approach to address the challenges about accessibility to records of other information about beneficial ownership. The Proposal states that the “known through reasonable inquiry” approach is consistent with current regulations and is a concept already understood. While we agree this phrase is present in other regulations, we are concerned the concept is not broadly understood and would result in confusion in application. We believe a straightforward approach for “reasonable inquiry” would include reviewing publicly available information and obtaining other information readily available to the issuer such as documents already in the possession of the issuer.

Excluding Other Funds That Would Be Considered Affiliates of the Audit Client

Applying the Loan Provision to certain affiliates in the investment fund context is particularly challenging since investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex. In addition, affiliates such as custodians and advisors typically do not have the ability to exercise significant influence over the audited entity. We believe investors in downstream entities generally do not possess significant influence over the fund; and therefore lending arrangements with shareholders in those entities would not present a threat to the accountant’s objectivity and impartiality. We suggest the Commission considering extending the proposed exclusion to apply to all entities that are not being audited by the accountant unless those downstream or other entities have significant influence.
Other Potential Changes to the Loan Provision

Materiality

We believe it would be beneficial to include a materiality qualifier especially if downward and other non-fund affiliates remain subject to the Loan Provision. In those situations, it seems unlikely that a lender's immaterial investment in an affiliate would impact an accountant's objectivity and impartiality.

Certain immaterial loans are excluded from the current rules as long as those loans were obtained under normal lending procedures and are at arms-length, and in certain situations are collateralized. We recognize the current rules are primarily designed to permit covered persons to have certain loans with audit clients because the loans do not present a threat to the accountant's objectivity and impartiality since the loans are immaterial and/or are collateralized. We suggest the current listing of loans covered by the Loan Provision be conformed to current loan types. For example, collateralized automobile, cash surrender value of an insurance policy and cash deposit loans are currently excluded, but we believe other types of immaterial loans that are collateralized should also be excluded. In addition, we do not believe the mortgage loan exemption should be limited to only primary residences since non-primary residences do not appear to present heightened risks to the accountant's independence.

Covered Persons and Immediate Family Members

We do not believe that certain covered persons or immediate family members should be carved out of the Loan Provision since they are included in the investments provision of Rule 2-01 (c)(1). Applying financial relationship restrictions consistently will reduce complexity and ease compliance while preserving independence.

Evaluation of Compliance

An accountant is required to be independent for the audit and engagement period so accountants should have procedures in place to monitor and ensure compliance with independence requirements during these periods. While we recognize there are practical difficulties in evaluating compliance especially for fund audits where ownership levels and structures may change frequently, it is still necessary for the accountant to ensure independence. We agree with the Commission's suggestion that on-going review could be limited to re-evaluating whether there have been any material changes in the fund's governance structure, governance documents or changes in publicly available information about beneficial owners. The proposed changes in the Loan Provision will reduce the challenges with compliance since the significant influence test is replacing the bright-line ownership level. We believe it will be much easier for accountants and issuers to identify when there has been a change in ownership that causes significant influence versus a percentage ownership change. Accordingly, we do not believe the Commission needs to provide special provisions for measuring compliance as of a certain date.

Other Changes to the Commission’s Auditor Independence Rules

We appreciate the Commission's inquiry about whether there are other changes needed to the auditor independence rules. We have identified the following areas where it would be beneficial for the Commission to evaluate whether the current rules may not be functioning as intended under current market and industry conditions.

Affiliate Rule

The SEC's current definition of an "affiliate of the audit client" includes entities where there is minimal, if any, opportunity for that entity to influence the audit client or for the audit client to influence that entity. For example, in the investment fund context there is rarely an ability to influence when dealing with
entities under common control. If the accountant had relationships with those entities, there would be no impact on the accountant’s objectivity and impartiality. As stated in the Proposal, this broad definition of affiliates presents compliance challenges with the independence rules and result in violations that a reasonable investor would not view as implicating an accountant’s objectivity and impartiality. We concur with the Commission’s comment in the Proposal that when numerous violations are reported over time, it is possible market participants will become desensitized and will not properly respond to more significant violations.

We believe the affiliate definition used by the AICPA or IESBA include the entities that present a reasonable risk to independence if the accountant had relationships with those entities. We encourage the Commission to consider modifying the affiliate definition to include entities that have control or significant influence over the audit client, or where the audit client can control or have significant influence and those entities are material to the audit client.

 Custody Rule

It is understood in the industry that the firms performing custody audits should comply with the SEC’s independence rules in conducting these audits even though they are not performed in accordance with the Public Company Accounting Oversight Board’s (PCAOB) standards. We encourage the Commission to consider modifying the requirement to follow the SEC’s independence rules since these audits are not performed in accordance with the PCAOB’s standards and we believe the accountant can be objective and impartial even if they are not complying with the more restrictive SEC independence rules. We believe the independence standards that are applicable to the auditing standards for those audits would be adequate.

 Transition

When an audit client undertakes an initial public offering (IPO), particularly an IPO that has not been planned years in advance, the audit client may be required to engage a new accountant if the current accountant is not in compliance with the SEC’s independence rules. We believe that a reasonable investor, when presented with the relevant facts and circumstances, would conclude that prior relationships that were permissible under independence rules applicable at the time of the audit do not impact the accountant’s objectivity and impartiality when later required to follow the independence rules of the Commission. For example, the Commission could provide transition rules that would require the accountant to comply with the Commission’s general standard for independence but allow the accountant to evaluate relationships and services covered by Rule 2-01(3)(4) and (5) to determine if they violate the general standard instead of categorically prohibiting those relationships and services.

 Safe Harbor

Rule 2-01(c) outlines non-audit services and business relationships that are prohibited as they are believed to violate the general standard of independence. Despite best efforts to comply with these requirements, inadvertent and immaterial violations may occur, in particular when providing non-attest services or entering into relationships with affiliates of the audit client. In many situations, these services or relationships involve a global network firm of the audit firm. After evaluating the violation, accountants and issuers typically conclude that a reasonable investor would not believe the accountant’s objectivity or impartiality has been impaired and the accountant can continue as the external auditor. Often this decision is reached after consulting with the SEC since the independence rules do not address inadvertent and immaterial violations, with the exception of when the violation is a result of a covered person’s inadvertent violation. We believe the Commission should consider expanding their current “safe harbor” provision as presented in Rule 2-01(d) to allow accountants to evaluate firm violations in the same manner as how a covered person’s violation is evaluated.
Business Relationship Rule

Accounting firms and issuers have evolved since the release of Rule 2-01 more than twenty years ago, which presents challenges in applying the extant business relationship rule. Accounting firms have changed their business and service models to include technology, contracting and subcontracting relationships, and other alliances and joint ventures. We believe it would be beneficial for the Commission to seek input from accounting firms, issuers, and perhaps other stakeholders, in order to provide new, or amended, guidance or non-authoritative guidance addressing current business relationships.

The current business relationship rule applies to "substantial stockholders in a decision-making capacity", which may include stockholders that do not have significant influence. Since the proposed Loan Provision is based on a "significant influence test", we recommend the Commission considering making a similar change to the business relationship rule by replacing the current "substantial stockholders in a decision-making capacity" requirement with a significant influence test. Providing consistency within the rules, when possible, eases compliance and reduces confusion and complexity while preserving independence.

We appreciate the opportunity to comment on this Proposal. Please contact Jennifer C. Kary at [redacted] or James A. Dolinar at [redacted] to answer any questions.

Sincerely,

Crowe LLP

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