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

File No. 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:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) request for comments on the amendments to the Loan Provision of Regulation S-X proposed in the Release for Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships (the Release or the Proposed Amendments). KPMG LLP (KPMG or the Firm) fully supports the efforts of the Commission to improve audit quality and efficiency through improvements to the auditor independence rules, and we welcome the opportunity to participate with the Commission, SEC staff (the Staff), and other stakeholders in this process.

The Commission has requested public comment on the Proposed Amendments to Rule 2-01(c)(1)(ii)(A) (the Loan Provision) in recognition that the Loan Provision is not functioning as intended in some circumstances and presents challenges to compliance. Further, the Commission observes that it is clear that instances of noncompliance in a variety of factual settings do not result in an impairment of the auditor's objectivity and impartiality. The Commission also seeks comment on certain other potential amendments to the auditor independence rules.

Overview

We thank the Commission for its consideration of the Loan Provision in view of the changes in the business environment that may necessitate reform. Auditor independence is the bedrock that underlies our profession and is essential to the value we provide clients and investors. We believe a key element of the Proposed Amendments is the recognition that when the independence rules are not aligned with the circumstances that can affect the auditor's objectivity and impartiality, the emphasis on the importance of auditor independence may be weakened. As observed in the Release, "numerous violations of the independence rules that no reasonable person would view as implicating an auditor's objectivity and impartiality could desensitize market participants to other, more significant violations of the independence rules. Respect for the seriousness of these obligations is better fostered through limiting violations to those instances in which the auditor's independence would be impaired in fact or in appearance."

It has been the experience of KPMG that the Release's observations are well-founded and reflect overbreadth in the scope of the Loan Provision, and as a result, the Loan Provision has required the expenditure of substantial resources to maintain compliance with the independence rules; to identify, document and communicate instances of noncompliance; and to assess the impact of the circumstances underlying noncompliance on the auditor's objectivity and impartiality. Neither the Firm nor those charged with governance at any audit client has concluded that there was an impairment of objectivity or impartiality of the Firm where violations of the types intended to be addressed by the Proposed Amendments have occurred. Accordingly, we welcome the Commission's proposal of changes to the Loan Provision in an effort to address these concerns.

The Release suggests four amendments that we believe would operate in concert and should be viewed as interdependent for the purposes of the proposal. In summary, we support the elimination of "record owner" from the Loan Provision, the inclusion of a "known through reasonable inquiry" standard, and the exclusion of "affiliate of the audit client" from the definition of "audit client" for purposes of the Loan Provision. While we also largely support the substitution of a "significant influence" test for the existing greater than 10 percent owner standard, we believe that the use of ASC 323 criteria for other than operating companies could present uncertainties in application and potentially inconsistent results. Specifically, we believe that the context to which ASC 323's guidance is directed, equity method accounting, is not necessarily analogous to determining the existence of "significant influence" of an owner under the governance models typical to fund structures, and that use of the 20 percent ownership test for the presumption of significant influence is not consistent with our experience, which typically suggests little correlation between the likelihood of an owner possessing significant influence over the fund's operating and financial policies and the proportionate size of the owner's holdings.

We believe that the questions posed in the Release and the request to identify costs and benefits of the Proposed Amendments are comprehensive of the issues for discussion, and we will provide our further thoughts in response.

Questions Presented in the Response

Section 1: Focus the Analysis Solely on Beneficial Ownership

A *Should the Loan Provision be analyzed by reference to beneficial owners rather than record owners? Why or why not?*

Yes. The experience of the Firm and its audit clients is convincing that inclusion of "record owners" in the Loan Provision does not further the objective of ensuring auditor independence and at the same time is an important factor resulting in the significant challenges faced by audit clients and audit firms in complying with the Loan Provision. As discussed in the Release, the record owner typically lacks control over acquisition or disposition of the investment and has no financial incentive to influence the audit client or the auditor. Indeed, our firm is not aware of ever having encountered a situation where the record owner has tried to influence the Firm or an audit engagement team in any manner. Parties identified as record owners of securities are typically holders or custodians of securities, act at the direction of the beneficial owner with respect to the voting of shares, and do not actually own the securities, share any economic interest in the investment or hold the dispositive rights of ownership.

In addition to the considerations noted in the Release, we also observe that there is no definition for the term "record owner" in SEC regulations and, in contrast to the requirements imposed on beneficial owners of registered securities, no regulatory disclosure requirements for record owners (or holders) of securities. These limitations significantly impede the audit client's identification of record owners. As observed in the Release, the process required by the current Loan Provision that necessitates identifying and assessing compliance with the Loan Provision and reporting instances of non-compliance to audit committees or others charged with governance is a cost imposed on audit clients that is ultimately passed onto shareholders or fund holders. Removing "record owners" from the Loan Provision would result in a meaningful reduction of time expended by audit clients in the identification of record owners and the auditor's consideration of any lending relationships the record owner might have with the firm or covered persons and the assessment of those relationships' impact on the audit firm's independence.

B Would eliminating the requirement to analyze record owners under the Loan Provision ease compliance challenges described above under Section 1.B.? Is there any further guidance the Commission should provide, or should the Commission consider alternatives?

Yes. In the Firm's analysis over the past two years of the greater than 10 percent owners of several thousand public and private funds where we perform the audit, the majority of lending relationships identified were with *record* owners of fund securities, for the reason that financial institutions (the customary lenders to accounting firms and covered persons) are much more likely to have the role of a custodian or nominee than that of a beneficial owner of fund securities.

We also note that although the term "beneficial owner" is defined generally in the Securities Exchange Act Rule, it is limited in application to owners of registered securities and could be enhanced to provide greater specificity. A more precise definition applicable to the Loan Provision would facilitate consistent identification and evaluation of beneficial ownership of investments in private funds and registered securities. For example, the new definition could indicate that a beneficial owner of securities is one with a direct economic interest in the performance of the investment as well as voting rights that enable the owner to exercise some form of influence over the governance of the issuer.

C Would eliminating the requirement to analyze record owners under the Loan Provision raise other concerns about the independence of auditors? If so, what concerns would it raise and why?

No. In our experience in applying the current rule, no circumstances have been identified where a lending relationship with a record owner without beneficial ownership resulted in a threat, in fact or appearance, to our objectivity and impartiality in performing our audit.

D If the Commission merely amended the Loan Provision to provide for evaluation of the beneficial owner, rather than record owner, would other proposed amendments be necessary or appropriate? Why or why not?

Yes. For reasons stated elsewhere in our response, we believe that the proposal to apply the Loan Provision solely to those investors who have significant influence over the audit client will have the greatest consequence to the efforts to strengthen the Loan Provision. In general, however, all of the Proposed Amendments would advance the goal of providing a clear focus on those relationships that could impact the audit firm's objectivity and impartiality in performing an audit. Should the elimination of "record owner" be the single change, the challenges of overinclusion observed in the Release would persist: ineffectiveness of the requirement to identify lending relationships with those beneficial owners who do not pose a threat to independence because of their lack of significant influence, over-reporting of violations that do not impair the objectivity and impartiality of the auditor to those charged with governance, and reporting of independence violations to affiliates without meaningful correlation to a threat of impairment at the affiliate.

We have summarized our recommendations throughout this letter for modifications to the Proposed Amendments as well as additional amendments to the Loan Provision. In addition to our comments and recommendations on the Proposed Amendments and other provisions of the rules, we believe that the Loan Provision should be amended to include guidance similar to the text below, reflecting the guidance provided by the Staff in footnote 5 to the no-action letter dated June 20, 2016 and repeated in footnote 22 to the Release regarding the identification of lenders implicated by the Loan Provision. That text reads:

> *For the purposes of identifying lending relationships implicated by the Loan Provision, the relevant institutions are those that control the entity that has significant influence over the operating and financial policies of the entity whose financial statements or other information are audited by the accountant (i.e., lenders that are under common control with or controlled by the entity with significant influence are not as such implicated by the Loan Provision).*

Section 2: "Significant Influence" Test

A *Should we amend the Loan Provision to replace the 10 percent bright-line test with a "significant influence" test? Why or why not?*

Yes. We support a test designed to identify owners with a "special and influential role" over the audit client, in the words of the adopting release of the Loan Provision (Release No. 33-7919), that is designed to determine whether a beneficial owner has significant influence over the audit client. Consistent with the Commission's views, we believe that such a test should focus "... on a lender shareholder's ability to influence the policies and management of an audit client, based on a totality of the facts and circumstances." We also agree with the observation in the Release that the analysis of whether a lender shareholder has significant influence should be based on the owner's "ability to exert significant influence over the audit client's operating and financial policies." As set forth more fully below, our experience applying the Loan Provision indicates that the current 10 percent bright-line test has not proved to be an effective measure to identify investors with significant influence.

B *Would the proposed reference to ASC's 323's provisions for "significant influence" effectively identify those lending relationships that may compromise auditor independence?*

We believe that a significant influence test premised on ASC 323 may not be a relevant measure to gauge the influence of investors in investment companies, including registered investment companies, non-registered investment companies and other registrants who employ investment company accounting in accordance with FASB ASC Topic 946, *Investment Companies*. Apart from that concern, there are also considerable implementation challenges posed by requiring the use of ASC 323 that would unduly

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complicate the analysis by these entities. We propose instead that the Commission adopt a decision framework with a singular focus on the beneficial owner's ability to exert significant influence over the audit client's operating and financial policies, based on the totality of the facts and circumstances, and avoid the complications that could result from exclusive reliance on the ASC 323 framework. As discussed more fully below, we support the suggestion that the framework of the "significant influence" test and criteria be codified in the Rule to provide a durable standard over time. We further recommend that the Proposed Amendments to the Loan Provision include a description of the limited circumstances in which investors in investment companies could have significant influence over the operating and financial policies of the investment company. For example, an investor in a registered investment adviser may also have investments in funds managed by the adviser. Although the investor does not have voting rights associated with its investment in the funds, its investment, if sufficiently large, and relationship with the adviser may enable the investor to have significant influence over the operating policies of the adviser and the funds.

C – D *Would amending the Loan Provision to replace the 10 percent bright-line test with a "significant influence" test, along with the other proposed amendments, address the compliance challenges that we identify above?*

Application of "significant influence" for financial reporting purposes and evaluation of auditor independence may not necessarily be congruent. Accordingly, does ASC 323 – Investments – Equity Method and Joint Ventures, provide an appropriate framework for analyzing "significant influence" in the context of the Loan Provision? Why or why not?

Investments in corporate registrants (non-investment companies)

We agree that ASC 323 (ASC 323-10) provides the appropriate framework for analyzing "significant influence" for most entities other than investment companies and their investment advisers. In most cases, ownership of 20 percent or more of the voting securities of a corporate registrant will result in the determination that the investor has significant influence over the operating and financial policies of the registrant. In addition, we believe that the provisions of ASC 323-10-15-6 through 15-11 provide the additional guidance necessary to determine when significant influence exists over the operating and financial policies of a corporate registrant.

Investments in registered and non-registered investment companies including limited partnerships and other limited liability corporations

The Release states that "the proposed significant influence test would be consistent with ASC 323 by establishing a rebuttable presumption that a lender beneficially owning 20 percent or more of an audit client's voting securities is presumed to have the ability to exercise significant influence over the audit client, absent predominant evidence to the contrary."

We do not believe that the securities ownership test in ASC 323 provides presumptive evidence of significant influence of owners in investment companies. For example, ASC 323-10-15-8 uses a voting securities interest concept which is usually not consistent with how lender shareholders do or do not gain significant influence of investment companies.

Our experience shows that rarely does an investor in an investment company have the ability to significantly influence the operating or financial policies of the audit client if the owner's rights are non-participatory in nature – regardless of the percentage of ownership. Thus, we recommend using a significant influence test for investment companies and their investment advisers that considers the totality of facts and circumstances excluding any factors that carry rebuttable presumptions, with the factors most significant to an investment company being those outlined in the Release: "In the fund context, we believe 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 (collectively "portfolio management processes")."

We do think that certain of the factors cited in ASC 323-10-15-6 could be considered in the analysis of whether investors in an investment company possess significant influence over the operating and financial policies of the investment company. Ultimately, because of the unique management and governance structures of registered and non-registered investment companies, it is our experience that there exist few, if any, situations in which an investor unrelated to the registered investment adviser actually has significant influence over the operating and financial policies of the investment company; indeed, we have encountered none.

Given the importance to an issuer of an investor having significant influence over day-to-day portfolio management policies, we believe that the management and/or board of directors of investment companies would be in the best position to identify and disclose to the auditor those investors that actually have significant influence, subject to the auditor's assessment of management's assertions.

E - F *Are there challenges associated with implementing the "significant influence" test that we should consider? Will accounting firms' and audit clients' relative experience with application of the "significant influence" test, given its use in other contexts, mitigate any such challenges? To what extent do audit clients lack experience with application of the significant influence test, and what costs would such audit clients bear in learning to apply the test? Will funds, which may have relatively less experience than operating companies with the significant influence test, face any particular challenges in applying the test?*

Is the proposed "significant influence" test sufficiently clear? Are there specific circumstances for which we should provide additional guidance? For example, we discuss above the application of the significant influence test in the fund context. Is the guidance sufficiently clear? Would the application of the significant influence test as applied to funds be effective in addressing the compliance challenges generated by the current Loan Provision while also identifying debtor-creditor relationships that may bear on an auditor's independence with respect to a fund client? Why or why not? Is there further guidance that we should provide or other approaches that we should consider?

Because the factors and considerations included in ASC 323-10 are not reflective of the particular circumstances of investment companies, these entities are not required to apply the provisions of ASC 323-10 for accounting purposes. The guidance in ASC 323-10 does not apply to limited partnerships, unincorporated joint ventures and limited liability companies that maintain specific ownership accounts for each investor. Investors in these types of entities instead apply the guidance in ASC 323-30.

To the extent that the Release is intended to direct that limited partnerships and limited liability investment companies look to ASC 323-10 to determine whether an owner has significant influence, such entities may find it difficult to implement the guidance. In our experience, investors with significant influence over operating and financial policies of limited partnerships and limited liability companies are more likely to have acquired their influence by means other than ownership of shares or voting interests. For example, a limited partner may own significantly more than 20 percent of a limited partnership, but have no influence because the limited partner has no right to participate in the actions through which the activities of the limited partnership are directed or to remove the general partner. Conversely, a general partner may have a one percent economic ownership of a limited partnership, but have exclusive authority to direct the activities that influence the entity's economic performance.

We anticipate that investment company audit clients (and their investment advisers) could be presented with challenges in implementing a significant influence test based on ASC 323 given their lack of experience in using a significant influence framework for accounting purposes. For many investment companies, we believe that these potential difficulties could be overcome by a test that recognizes a practical understanding by managers of which owners, if any, possess actual significant influence over the operating and financial policies of the entity or fund. We encourage the Commission to give particular consideration to the significance to be accorded an owner's participation in an advisory committee of a fund, as it has been our experience that this role does not confer on the owner significant influence over the fund's operating or financial policies; rather, we believe that participation in an advisory committee is one factor that should be considered by management and the audit firm when evaluating if any entities have significant influence over the operating and financial policies of the audited entity/fund.

G *Should the "significant influence" test (or specific elements) be codified in our rules? Why or why not?*

Yes. We support codification of the "significant influence" test to facilitate a consistent basis for its application over the passage of time. As discussed above, we suggest that the codified rule avoid bright-line tests and be adaptable for different types of entities, *e.g.*, private funds, registered investment companies and operating companies.

H *Authorized participants ("APs") for ETFs deposit or receive basket assets in exchange for creation units of the fund. We believe 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. Should we provide additional guidance about the proposed "significant influence" test with respect to APs? Similarly, should we provide additional guidance about the proposed "significant influence" test with respect to a market maker that is also a lender to the auditor and that engages an AP on an agency basis to create or redeem creation units of the ETF on its behalf?*

Yes. Beneficial ownership of securities by APs, where it exists, is usually temporary, as APs seek to transfer beneficial ownership of underlying securities embedded in creation units of an exchange-traded fund (ETF). Additional guidance with respect to ownership of securities by APs should give consideration to the temporary nature of the ownership by APs and the fact that this circumstance may limit the influence of the AP. This is another area, we submit, where examples relevant to APs would aid compliance with the Loan Provision.

I *ASC 323 includes a rebuttable presumption of 20 percent. For purposes of the Loan Provision and the proposed significant influence test, should the rebuttable presumption be lower or higher than 20 percent? Would a lower threshold (e.g., 10 percent) be more likely to capture relevant independence-impairing relationships, or to result in additional false positives that the proposed rule seeks to avoid? Would setting our threshold differently*

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than ASC 323 diminish the benefits that we seek to achieve by using an existing standard—e.g., by requiring the reperformance of certain analyses at a greater degree of sensitivity? How much more complex would it be to apply a threshold other than 20 percent? Are there further relevant facts about a lower or higher threshold that we should consider?

For the reasons discussed above, we believe that the provisions of ASC 323-10 generally provide an appropriate framework for the determination of significant influence over corporate registrants. Such framework utilizes a threshold of 20 percent of the voting securities as presumptive evidence of significant influence.

Conversely, also as discussed above, we believe that the Commission should avoid using a bright-line test for the significant influence test for investment companies (registered and non-registered), and accordingly should not apply a rebuttable presumption of 20 percent ownership for purposes of the significant influence test in the Loan Provision for these entities. Instead, the Proposed Amendments to the Loan Provision should require clients and auditors to consider the totality of facts and circumstances that are indicators of significant influence applicable to the investment in the audit client, which should include factors appropriate to the form of the entity, in addition to relevant criteria supplied in ASC 323. We believe that the factors described in ASC 323-10-15-6 may be useful to apply in all situations including investments in investment companies.

J *Would the proposed amendment raise any new concerns regarding auditor independence (e.g., are there circumstances related to lending relationships in which an auditor's independence should be considered impaired that would not be identified under the proposed "significant influence" test)? Conversely, would the proposed "significant influence" test result in an auditor's independence being considered impaired in circumstances under which the auditor should otherwise be considered independent?*

Even under the amendments to the Loan Provision as proposed, we can conceive of situations in which an audit firm or covered person in the firm has a loan from an entity with significant influence over the operating and financial policies of an audit client that does not impact the ability of the audit firm to be objective and impartial in the performance of an audit of the client's financial statements or internal controls over financial reporting. For example, the Proposed Amendments do not exempt immaterial loans that originated prior to the date on which the loans triggered a violation of the Loan Provision.

K *Should we consider alternatives to this test? If so, what tests should we consider, and what would be the anticipated costs and benefits? For example, should the modifier "significant" be removed, such that the test hinges on whether a lender shareholder has influence over an audit client? What is the difference between "influence" and "significant influence" in the auditor independent [sic] context and how does that difference inform the test?*

We support the adoption of a "significant influence" test, consistent with the observations above as they address the particular circumstances of investment companies and their advisers, with greater emphasis on guidance and examples of the application of the test ultimately adopted. We do not believe a simple "influence" test would achieve the objectives set out by the Commission. First, it would be extremely challenging to implement a test based on influence alone in a consistent and meaningful manner. Second, it would greatly enlarge the scope of the owners to be examined for prohibited lending relationships,

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substantially negating the gains sought by the Proposed Amendments in efficiency and reducing unnecessary costs to audit clients and audit firms, and reductions in excessive notifications of violations that do not result in objectivity or impartiality being impaired in fact or appearance.

L *Should the nature of the services provided by the investment adviser be part of the significant influence test as proposed? Why or why not?*

We believe that all relevant facts and circumstances should be considered in connection with the evaluation of parties that have control or significant influence over an audit client. The services provided and responsibilities of the investment adviser could be a factor in determining whether any owner could be deemed to have significant influence over an investment company or private fund.

Section 3: "Known Through Reasonable Inquiry"

A *Should the Loan Provision include a "known through reasonable inquiry" standard? Why or why not? What alternatives should we consider?*

Yes. We support the inclusion of a "known through reasonable inquiry" standard in the Loan Provision for several reasons. First, we believe that it is reasonable to expect that registrants and advisers will be able to identify those investors who have significant influence over the operating and financial policies of the audit client. Second, guidance implementing the Loan Provision should recognize the responsibility of management to identify those entities that have significant influence over such policies by answering the straightforward question of whether there are outside investors who can require management to alter the operating and financial policies of the fund, and recognize the separate responsibility of the auditor to test those determinations. Third, under the existing rule, with no "reasonable inquiry" qualifier, considerable resources are expended by the audit client in extensive and typically unproductive efforts to obtain the identity of beneficial owners from record owners who are prohibited by agreements with the beneficial owners from disclosing their identities. Finally, we agree with the statement in the Release that it is difficult to conceive of circumstances in which the auditor's objectivity or impartiality could be impaired by a lending relationship with an entity that the engagement team has been unable to identify as a beneficial owner of the audit client after reasonable inquiry, and of which the team is actually not aware.

B *Would the proposed "known through reasonable inquiry" standard with respect to identifying beneficial owners help to address compliance challenges associated with the Loan Provision?*

Yes. As observed in the Release, the identities of certain beneficial owners are not disclosed to the audit client for a variety of reasons, and in some instances the record owner is prohibited by its agreement with the beneficial owner to disclose the owner's identity to third parties. While the challenges in identifying all beneficial owners are real, it is difficult to envision a situation where the identity of a beneficial owner who has the power to significantly influence the operating and financial policies of the audit client is unknown to management of the audit client.

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C *Are there specific circumstances for which we should provide additional guidance about the proposed "known through reasonable inquiry" standard?*

We have considered our experience and that of our audit clients in conducting inquiries to identify beneficial owners under the current rule and did not identify any specific circumstances where additional guidance would be necessary.

D *Does the "known through reasonable inquiry" standard raise any new concerns regarding auditor independence (e.g., are there circumstances related to lending relationships in which an auditor's independence should be considered impaired that would not be identified under the proposed amendment and the use of "known through reasonable inquiry" standard)?*

To the extent that the Proposed Amendment suggests that the auditor's independence is impaired immediately upon subsequent identification of a lending relationship that was not previously known through the performance of reasonable inquiry and evaluation procedures, we believe that the Commission has the opportunity to modify the Proposed Amendment to include a reasonable transition period to allow the auditor to assess and remediate the situation without violating the Loan Provision. For example, if the existence of the previously unknown lending relationship did not impair the auditor's objectivity and impartiality and the prohibited loan was terminated within a reasonable transition period, the auditor would remain independent in accordance with the provisions of Rule 2-01. We also suggest that the Commission consider "grandfathering" provisions for immaterial and secured lending relationships that the accounting firm or covered persons had with the lender prior to becoming subject to the Loan Provision.

E *Alternatively, should we amend the Loan Provision to apply the significant influence test to "known beneficial owners" of an audit client's equity securities, without also including a reasonable inquiry standard, consistent with the way beneficial owners are treated elsewhere in Regulation S-X (that is, when assessing compliance with the Loan Provision, the determination would encompass assessing whether the known beneficial owners have significant influence over the audit client)?*

As discussed in our response to the first question of this section, we believe that a "known through reasonable inquiry" standard provides the auditor useful guidance in the diligence required to carry out its obligations under the Loan Provision.

Section 4: Proposed Amendment to Exclude from "Audit Client" Other Funds that Would Be Considered an "Affiliate of the Audit Client"

A *Should affiliates of an audit client be excluded from the definition of "audit client" as it relates to the Loan Provision? Why or why not?*

Yes. In our experience, investments in entities in common control relationships or in an investment company complex with the audit client generally do not create significant influence over the operating and financial policies of the entity under audit, as the structure of funds typically does not permit an investor in one fund to influence the policies or management of another fund in the complex. Including affiliates of an audit client in the definition of "audit client" for purposes of the Loan Provision results in the identification of relationships that do not impair the objectivity and impartiality of the auditor in fact or appearance. For that reason, affiliates of the audit client should be excluded from the definition of "audit client" as it relates to the Loan Provision. This guidance should not be limited to affiliates that are funds or other entities in an investment company complex, but should apply to all affiliates of all audit clients. We believe that amending the "audit client" definition in this fashion for purposes of the Loan Provision will provide substantial savings in costs for audit clients' affiliates, which in certain cases otherwise could be required to engage new auditors as a consequence of an independence impairment occurring at their affiliate.

In some cases, however, significant influence could result from indirect investments in an entity, such as investments in an entity that controls or is controlled by the entity whose financial statements are audited by the firm (*i.e.*, an affiliate of the audit client).

The guidance also should take note of situations where the policies for the portfolio management of the fund under audit span a wider group of funds. For example, an investor may have significant influence in a large fund in the complex that could result in effective influence over a sister fund, where both funds are managed by the same team under the same policies.

We believe that the guidance should require the identification of those entities that have significant influence over the operating and financial policies of the entity whose financial statements are audited by the firm. Using the guidance included in the Loan Provision, the registrant's management should identify those parties that have significant influence over its operating and financial policies. The auditor would be responsible for assessing and evaluating the completeness and accuracy of management's assertions.

B Would the proposed amendment to exclude from the term "audit client" for a fund under audit any other fund that otherwise would be considered an "affiliate of the audit client" address compliance challenges associated with the Loan Provision while still effectively identifying lending relationships that may impair auditor independence?

Yes. Consistent with our response to the first question of this section, we believe that excluding sister funds and other entities within the investment company complex from the term "audit client" (including sister entities that are "affiliates of the audit client") is appropriate and will address many of the unnecessary compliance challenges associated with the Loan Provision.

As long as the Loan Provision retains the requirement to identify those entities that have significant influence over the operating and financial policies of the entity whose financial statements are audited by the firm, we believe that the Loan Provision will effectively identify lending relationships that may impair auditor independence. Considering that some of the relationships described in our response to the first question of Section 4 could possibly result from investments or other relationships with affiliates of an audit client, it is our view that relationships with affiliates should not be automatically included or excluded from consideration when evaluating compliance with the Loan Provision.

C Would the proposed amendment appropriately exclude funds of an "investment company complex" (other than the fund under audit) that are currently within the Loan Provision's ambit?

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Yes, we agree that the amendment proposed in the Release appropriately excludes the other funds of an investment company complex; however, we believe the exclusion should be extended to other affiliates of the audit client as discussed above so that the significant influence test is focused only on those entities that have significant influence over the audited entity.

D *Alternatively, are there other changes we should consider to the Loan Provision to appropriately exclude certain affiliated funds?*

See our response to the first question of this section.

Section 5(A): Materiality

A *Should we include a provision for assessing materiality in the Loan Provision such that an auditor's independence would only be impaired as a result of certain relationships where the lender to the auditing firm has beneficial ownership in the audit client's equity securities and that investment is material to the lender or to the audit client (and the lender has the ability to exercise significant influence over the audit client)? Would that approach more effectively identify lending relationships that are likely to threaten the auditor's objectivity and impartiality? Would focusing on the perspective of the lender, the audit client, or both be the most effective barometer of independence?*

As long as the amendments to the Loan Provision focus the rule exclusively on loans with entities that have significant influence over the operating and financial policies of the entity whose financial statements or other information is being audited, it will not be necessary or useful to add a materiality provision for the lender's investment. The existing independence rules include a materiality component when identifying affiliates of the audit client in significant influence situations. For example, an entity over which the audit client has significant influence or which has significant influence over the audit client is excluded from the definition of "affiliate of the audit client" (Rule 2.01(f)(4)) if the relationship is immaterial to the investor. If it is determined that an investment in the audit client is material to the investor, the investor would be deemed to be an affiliate of the audit client. Under existing independence rules and under the approach proposed in the Release, the audit firm, associated entities of the firm and covered persons are not permitted to have loans with the audit client or its affiliates.

As an alternative to consideration of materiality of the lender's investment, we believe that the Proposed Amendments should expand the existing exceptions to exclude from consideration loans with the audit firm or a covered person that are immaterial to the audit firm or covered person, and that were obtained in an arms-length relationship. Experience and practical considerations suggest that loans that are immaterial to the audit firm or the covered person would have far less potential to affect the objectivity and impartiality of the auditor, or to give the appearance of impairment of independence to a reasonable investor. Furthermore, including a materiality component in the Loan Provision applicable to loans with non-affiliate entities that have significant influence over the audit client would make the Loan Provision more consistent with other independence rules, such as the rule governing investments in non-affiliate entities over which the audit client has significant influence but which are not material to the audit client (Rule 2-01(c)(1)(i)(E)(2)). We think the exception also should apply to lending relationships of member firms in the same network as the audit firm that are not participating in the audit as those relationships are not material to the audit firm, so long as the audit firm is not obligated under the lending relationship.

B *If we were to add a materiality qualifier to the Loan Provision as described above, which qualitative and quantitative factors should be considered in making the materiality assessment? Would such a materiality assessment add unnecessary complexity to the significant influence analysis? Would a materiality qualifier tend to exclude most lending relationships from the Loan Provision? What guidance, if any, should the Commission provide?*

We do not believe it is necessary to supplement the Loan Provision to offer specific guidance on the determination of materiality. Audit firms and covered persons are accustomed to assessing materiality at the firm and covered person level for other types of financial interests where materiality is a consideration, and we are not aware of distinctions that would suggest those assessments be performed differently in the context of the Loan Provision.

We do believe that adding a provision excluding loans that are immaterial to the accounting firm or covered person will reduce some of the challenges faced in complying with the Loan Provision and avoid possible liquidation of loans that are immaterial, and would not affect the auditor's objectivity or impartiality.

Section 5(B): Accounting Firms' "Covered Persons" and Immediate Family Members

A *Should we amend the definition of "covered person" for purposes of the Loan Provision or elsewhere in the auditor independence rules, and if so, how should the definition of "covered person" be amended?*

Yes, we support amending the definition of "covered person" for purposes of loans with entities that have significant influence over the operating and financial policies of an audit client. The current definition of "covered person" for purposes of the Loan Provision is broad and problematic from a compliance perspective. Further, the broad definition sweeps in numerous professionals who, in our view, could not affect the objectivity or impartiality of the audit engagement team.

Accordingly, we believe it would be appropriate to exclude persons who are not members of the audit engagement team or persons in the chain of command from the definition of "covered person" for the purpose of compliance with rules for loans with entities that have significant influence over the operating and financial policies of an entity audited by the audit firm.

B *In particular, taking into account the proposed "significant influence" test, should we, for example, remove or revise the part of the current definition that includes any partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit? Should all of these persons practicing out of an office from which an audit is conducted be included? Should immediate family members be removed from the definition? Why or why not?*

We are mindful that the SEC's definition of "covered person" is similar to provisions in extant codes of ethics published by the American Institute of Certified Public Accountants (AICPA) and the International

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Ethics Standards Board for Accountants (IESBA). For that reason, we recognize that it may not be appropriate at this time to amend the definition of "covered person" to exclude partners, principals and shareholders from an "office" in the accounting firm in which the lead partner primarily practices in connection with the audit. However, we believe that it would be appropriate to include the topic of amending the definition of "covered person" for purposes of the Loan Provision as well as other financial relationships in Rule 2-01(c)(1)(ii) on the list of topics that should be considered as part of the Commission's future efforts to strengthen and improve the auditor independence rules.

As observed in the proposing release of the Loan Provision (Release No. 33-7870), "We included these people because we believe they are generally in a position to influence the audit. They are the ones most likely to interact with the audit engagement team on substantive matters and to exert influence over the audit engagement team by virtue of their physical proximity to, or relatively frequent contact with, the audit engagement team." However, the Commission also noted in the original proposing release that "there is increased mobility of professional employees". We submit that in the ensuing nearly two decades at large accounting firms, the second observation has eclipsed the first: today, a partner on an SEC audit engagement may be working next door to another partner in his or her office but is just as likely to be working from a client location, a home office or across the country. We believe the presumption of geographic influence is not consistent with current circumstances and poses no practical threat to the independence of the audit partner or others on the engagement.

Accordingly, we believe that the definition of "covered person" should include members of the audit engagement team and the accounting firm's chain of command, and their respective immediate family members. Based on the experience of our firm, the inclusion of those providing non-audit services or partners practicing from the office of the lead audit engagement partner does not serve any practical purpose in preserving auditor independence.

C *In addition, the Loan Provision provides that it does not apply to certain loans made by a financial institution under its normal lending procedures, terms, and requirements, such as automobile loans and leases collateralized by the automobile. Should we consider expanding or otherwise modifying the specific types of loans that will not implicate the Loan Provision, given that the Loan Provision applies to covered persons of the accounting firm and their immediate family members? For example, should the Loan Provision address student loans or partner capital account loans? If so, how should it address them? For example, should it exclude them altogether or exclude them under certain conditions? If so, under what conditions?*

The existing loan exceptions have in common the recognition that certain lending relationships with covered persons do not pose a significant threat to the professional's objectivity and impartiality. Expanding the existing exceptions as discussed below would be consistent with the reasoning in the proposing release for the Loan Provision and would not result in an increased risk to the auditor's independence.

<u>Audit Clients, including affiliates of audit clients</u>

Based on inherent compliance challenges and immaterial risks to objectivity and impartiality, we encourage the Commission to consider expanding the types of loans that would not implicate the Loan Provision to include all secured loans, and those unsecured loans that are immaterial to a covered person's net worth and

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were obtained from a lending institution under normal lending terms, conditions and procedures, provided the loan was not obtained while the individual was a covered person in the firm.

Other Entities that have Significant Influence over the Audit Client

Current AICPA and IESBA codes of ethics do not address loans held with financial institutions that have significant influence over the operating and financial policies of audit clients unless those financial institutions are also affiliates of the audit client. We do not believe it is necessary to identify specific types of loans that should be excluded from consideration. Instead, we believe that the Commission's rules should exclude from consideration loans with non-affiliate entities that have significant influence over the operating and financial policies of the audit client when the loans are immaterial to an audit firm or covered person's net worth.

Section 5(C): Evaluation of Compliance

A *Should the rule provide that auditor independence may be assessed in reliance on such disclosures? Should we make any changes related to the frequency with which, the date as of which, or circumstances under which, an auditor must assess compliance with the Loan Provision or other provisions of Rule 2-01 of Regulation S-X? More specifically, should we permit the Loan Provision or other financial relationships to be assessed at specific dates during the audit and professional engagement period, or the beginnings or ends of specific periods, or under specified circumstances? If so, what would be appropriate dates, periods, or circumstances?*

As observed in the Release, a requirement of continuous monitoring of compliance during both the audit and professional engagement periods is complex given the potential for frequent changes in the identity of owners and percentage of ownership of the clients' securities, and in the loan relationships entered into by the accounting firm, member firms and covered persons. In addition, it is difficult to conceive of a situation where a lending relationship between an owner and firm or covered person that went undetected by the auditor within the audit or professional engagement period presented an actual threat to independence.

Accordingly, we believe that the auditor should be permitted to satisfy its obligations under the Loan Provision by assessing compliance at specific dates during the audit and professional engagement period, such as the onset of the engagement period and the balance sheet date for each audit. In recognition that certain of the procedures followed by audit firms and clients represent *detective* controls, in instances where an owner with a prohibited lending relationship is newly identified to have obtained significant influence over the audit client, there should be a transition period for the auditor or covered person to modify or terminate the lending relationship, during which the auditor would be able to assert compliance with the Loan Provision.

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B *We believe that if the auditor determines that significant influence over the fund's management processes could not exist, the auditor could monitor its independence on an ongoing basis by reevaluating its determination in response to a material change in the fund's governance structure and governing documents, publicly available information about beneficial owners, or other information which may implicate the ability of a beneficial owner to exert significant influence of which the audit client or auditor becomes aware. Would this approach be sufficient for evaluating compliance with the Loan Provision? Why or why not?*

Yes, we agree generally with the approach described. We also believe that it is reasonable to expect the audit client to determine the parties that have significant influence over the audit client and to disclose the identity of those parties to the auditor. The auditor would assess compliance with the Loan Provision based on such information.

Section 5(D): Secondary Market Purchase of Debt

The existing Loan Provision encompasses lending arrangements that may change depending upon secondary market purchases of syndicated or other debt. For example, audit firms may issue private placement notes for financing purposes, which could then be sold on the secondary market to new purchasers thereby creating new lending relationships between the audit firm and these new secondary market purchasers. Should such secondary market relationships be taken into account or excluded from the Loan Provision? Do secondary market relationships raise concerns about auditor independence?

As we understand the term as used in the Release, "secondary market purchasers" refers to situations where a note payable issued by an audit firm is sold by the original purchaser of the notes to another entity or when the holder of the note payable is acquired by another company. We propose that the Loan Provision exclude from consideration loans that are acquired, either through secondary market purchase or as a result of an acquisition, by an entity that has or obtains significant influence over an audit client unless the total value of such loans is material to the audit firm. Those types of situations could require further evaluation to assess the potential impact on the auditor's objectivity and impartiality on a go-forward basis.

Section 5(E): Other Changes to the Commissions' Auditor Independence Rules

A *Should we make other changes to our auditor independence rules? If so, which rules and why?*

Yes. We appreciate the opportunity to offer suggestions to the Commission regarding specific provisions of the independence rules that could be improved. Overall, we believe that the Commission's auditor independence rules work well to protect investors and promote investor confidence about the quality and accuracy of financial statements. With the passage of time and changes in markets and capital formation processes, regulation, corporate structures and technology, however, certain provisions of the rules may not be functioning as intended. When the application of specific provisions of Rule 2-01(c) of Regulation S-X are inconsistent with the general independence standard in Rule 2-01(b), it serves the public interest to consider modifications to Rule 2-01 to re-align the specific requirements to the general independence standard. As the Commission noted in the Release, "It 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". Based on our experience in applying the Commission's auditor independence rules, we recognize there are other provisions of the rules where it is clear that the auditor's objectivity and impartiality is not impaired by the situation that resulted in the violation. We agree with the Commission's statement in the Release that "respect for the seriousness of these obligations (*i.e.*, compliance with independence rules) is better fostered through limiting violations to those instances where the auditor's independence would be impaired in fact or appearance."

Despite the overall strength of the design of the Commission's auditor independence rules, it is reasonable to expect that the rules may require periodic review and maintenance. In the spirit of continuous improvement, we have proposed three changes to Rule 2-01 that we believe will advance the alignment of the specific provisions of Rule 2-01(c) and (d) with the general independence standard in Rule 2-01(b). The amendments we propose below will reduce the effort and focus on less significant services and relationships and thus improve the focus and operation of Rule 2-01(c) and (d) on those relationships that could reasonably threaten, in fact or appearance, the auditor's objective and impartial judgment in its audits.

<u>Non-audit services for non-audit affiliates of an Audit Client</u>

Rule 2-01(c)(4) of Regulation S-X provides that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides one of the ten non-audit services described in the rule to an audit client. The term "audit client" includes the entity subject to audit procedures as well as the affiliates of the audit client. The non-audit services described in Rule 2-01(c)(4)(i-v) will impair the accountant's independence unless it is reasonable to conclude that the results of these services (*i.e.*, bookkeeping, financial information systems design and implementation, appraisal and valuations, actuarial and internal audit services) will not be subject to audit procedures during an audit of the audit client's financial statements.

Often described as the "reasonable to conclude" exception to the rules for certain non-audit services, the exception provides that the non-audit services described above will not impair the accountant's independence when the services are provided to non-audit affiliates of the audit client. Non-audit affiliates of an audit client are the parent or other upstream affiliates of the audit client as well as entities that are under common control with the entity whose financial statements or other information are audited by the audit firm. When providing these services to non-audit affiliates of an audit client, there is often no impact on the accountant's ability to remain objective and impartial in the evaluation of all matters encompassed in the audit of the client's financial statements and, accordingly, there is an exception in the rule (*i.e.*, a permission) when these services are provided to non-audit affiliates.

Regulation S-X does not include a similar exception for services in sections (vi-x) of Rule 2-01(c)(4). For example, when the accountant provides any of the specified non-audit services (management functions, human resources, broker-dealer/investment adviser, legal or expert services) to an audit client or any affiliate

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of the audit client during the audit or professional engagement period, the provision of that service will be deemed to impair the accountant's independence.

Since the Commission first adopted the current definition of "audit client" and "affiliate of the audit client", the expansion of the private equity industry and the applicability of the SEC's Custody Rule (Rule 2-06(4)-2(b)(4)(ii) of the Investment Advisers Act of 1940) has greatly expanded the number of audit clients and affiliates of audit clients that are subject to SEC independence rules. Audit clients that are portfolio companies controlled by private equity groups and private funds audited for purposes of the SEC's Custody Rule oftentimes have a significant number of affiliates comprising an unconsolidated group of companies and funds. As a result, client management and audit firms can spend a significant amount of time and effort to track and evaluate non-audit services provided to numerous affiliates in a private equity complex. Over the years, we have identified the existence of certain impermissible services performed at non-audit affiliates, particularly in the evaluation of independence for prospective audit clients, new affiliates of existing audit clients and audit clients pursuing an initial public offering. In nearly all of the situations we have identified and evaluated, the performance of the impermissible service at a non-audit affiliate of the audit client reasonably could not have affected, and did not in fact affect, the ability of the firm to remain objective and impartial, in both fact and appearance, in the performance of the audit of the client's financial statements.

Based on this experience and the Staff's knowledge and experience with similar matters, we believe that the Commission should consider amending Rule 2-01(c)(4)(i-x) of Regulation S-X to provide that the accountant's performance of non-audit services described in these sections will not impair the accountant's independence as long as it is reasonable to conclude that their performance will not be subject to audit procedures and will not affect the accountant's objectivity and impartiality, in both fact and appearance, in performing the audit of the client's financial statements (and internal control over financial reporting, if applicable). For example, a member firm in the same international network as the accountant may have provided prohibited human resources services and valuation services to an entity under common control with a prospective audit client (*i.e.*, non-audit affiliate) during the period subject to audit. The services have no impact on a prospective audit client (the entity whose financial statements will be audited by the firm), and the member firm that performs the non-audit service will not participate in the audit of the client's financial statements. In fact, management of the prospective audit client is not aware of the sister company's existence prior to the identification of this matter. The two entities are in different lines of business, have different management and boards of directors and the only thing connecting the two companies is that they are both controlled by entities controlled by the same private equity firm. In this situation and many like it, we believe that there is no reasonable possibility that either the human resources service or the valuation service could impair the objectivity and impartiality of the firm, in fact or appearance.

This proposed amendment is consistent with the Commission's objectives of strengthening the rules by enabling greater focus on those relationships which could reasonably impact an accountant's objectivity and impartiality in fact or appearance. Rule 2-01, if amended as we have proposed, would include the "reasonable to conclude" exception to all of the prohibited services described in Rule 2-01(c)(4)(i-x), but would still require the accountant to evaluate relationships with and services provided to all affiliates of the audit client. The amended rule would enable the accountant and the audit committee to conclude on the accountant's independence by evaluating whether non-audit services provided to non-audit affiliates could reasonably impact the accountant's ability to be objective and impartial on all matters encompassed in the audit of the client's financial statements and internal control over financial reporting, in fact and appearance.

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We note that this is consistent with the approach followed under the independence standards of the AICPA (ET 1.224.010.02-b) and IESBA (Code of Ethics for Professional Accountants §290.157).

Non-audit services and other prohibited relationships with new affiliates of an audit client

Rule 2-01 of Regulation S-X does not include any provisions for pre-existing services and relationships between an accountant and entities not subject to the independence rules (*e.g.*, non-audit clients that are not affiliates of an audit client) when those entities become affiliates of an audit client. For example, Rule 2-01 does not include a transition provision if impermissible services or relationships with new affiliates are identified.

Many accounting firms have established quality control processes to help ensure that the firm does not enter into impermissible relationships with SEC audit clients. For example, KPMG International (the Swiss cooperative network of which KPMG is a member firm) has implemented a services approval system across all firms in the KPMG network to facilitate the internal independence review and approval of all services proposed to be provided to audit clients and support the required procedures to obtain audit committee pre-approval of all services provided to SEC issuer audit clients.

While quality control processes are designed to facilitate the identification and evaluation of proposed services and relationships with existing audit clients, ongoing challenges include timely identification and evaluation of relationships with new affiliates of existing audit clients as well as issues that may arise when an audit client plans an initial public offering of securities. We believe that registrants and accountants can prevent most violations resulting from these situations by recognizing the shared responsibility of registrants and accountants for compliance with the independence rules, while working to continuously improve quality control processes and the quality of information used to monitor compliance. For example, our firm has established procedures that help us identify corporate transactions involving our issuer audit clients that are disclosed in filings with the SEC. These and other procedures enable our firm's Independence Group and audit engagement teams to identify services and relationships with entities before they become affiliates of an audit client so the firm can take actions necessary to maintain compliance with SEC independence rules.

Consistent with the Commission's stated objectives of aligning specific provisions of the rules to the general standard for independence, we believe that the independence rules can be strengthened and thus improved by amending Rule 2-01(d)(4) to add quality controls for non-audit services and business relationships and expanding the temporary relief provisions of Rule 2-01(d)(1), (2) and (3) (Rule 2-01(c)(1)(iii)) to cover additional non-audit services and business relationships of associated entities of the firm as long as the services and relationships do not impair the accountant's ability to comply with the requirements of Rule 2-01(b).

Business relationships with persons associated with an audit client in a decision making capacity

Rule 2-01(c)(3) of Regulation S-X provides that "[a]n accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with an audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business."

With similarities to the Loan Provision, the Commission's rule covering business relationships is one of the few provisions within Rule 2-01 that covers relationships with entities other than audit clients (including officers and directors of the audit client) and affiliates of audit clients. Specifically, this rule also covers direct or material indirect business relationships with persons associated with the audit client in a decision-making capacity, such as officers, directors or substantial stockholders. While it is generally understood that officers and directors of an audit client are in decision-making roles at the audit client, the term "substantial stockholder" is not defined in Rule 2-01 and it cannot be assumed that stockholders who may be identified as a substantial stockholder actually have decision-making authority over the operating and financial policies of the audited entity.

In order to strengthen the rules and improve consistency of the application of Rule 2-01, we propose that the Commission amend Rule 2-01(c)(3) in a manner consistent with the Proposed Amendments to the Loan Provision. Specifically, the amendment would replace the term "substantial stockholders" with "other persons or entities who have significant influence over the operating and financial policies of the audited entity".

B *Would our proposed amendments have any unintended impact on other professional standards that may exist, such as the requirements of the PCAOB, professional societies, or state boards of accountancy?*

We do not believe that the Proposed Amendments or the additional amendments we propose would interfere with or have other consequences to the interpretation of other standards or present any conflicts in auditors' compliance with other standards. We note that the Loan Provision requirement regarding loans with owners of more than ten percent of an audit client's securities is unique to Regulation S-X, and accordingly the amendments contemplated do not present apparent areas of inconsistencies or overlapping requirements or guidance.

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We appreciate the opportunity to respond to the Proposed Amendments. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Lawrence Bello, Partner in Charge, Independence ([redacted]) or William J. McKeown, Partner, Independence ([redacted]).

Very truly yours,

KPMG LLP

cc:

SEC

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