Stanford Law School

Joseph A. Grundfest
W. A. Franke Professor of Law and Business
Senior Faculty, Rock Center for Corporate Governance

Crown Quadrangle
559 Nathan Abbott Way
Stanford, CA 94305-8610
Tel [redacted]

July 9, 2018

VIA EMAIL: Rules-comments@sec.gov

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

Re: File Number S7-10-18, Auditor Independence with Respect to Certain Loans and Debtor-Creditor Relationships (SEC Rel. Nos. 33-10491; 34-83157; IC33091; IA-4904)[*]

Dear Mr. Fields:

The Securities and Exchange Commission, on May 2, 2018, proposed to amend its Auditor Independence Rules to, *inter alia*,

> focus solely on beneficial ownership rather than on both record and beneficial ownership; replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test, add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and amend the definition of "audit client" for a fund under audit to exclude funds that would otherwise be considered affiliates of the audit client. [1]

I strongly support the Commission's proposed rule changes and urge, more broadly, that the Commission adopt an approach consistent with the "economic realities" test frequently espoused by the United States Supreme Court in its interpretation of the federal securities laws. [2] Mechanistic rules that fail to recognize the realities of modern capital

[*] The views expressed in this letter are my own and do not necessarily reflect the views of Stanford Law School, Stanford University, or of any affiliate of Stanford Law School or Stanford University.

[1] Auditor Independence with Respect to Certain Loans and Debtor-Creditor Relationships (SEC Rel. Nos. 33-10491; 34-83157; IC-33091; IA-4904) 83 Fed. Reg. 20753 (cols. 2,3) (May 8, 2018).

[2] *See, e.g.* William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto, June 14, 2018, at 2-3 *quoting SEC. v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946) ("Form [is] disregarded for substance and the emphasis

markets can ascribe conflicts when there are none, and thereby harm the very shareholders whose interests are to be protected by the auditor independence rules.

To provide context, I am the William A. Franke Professor of Law and Business at Stanford Law School where I am also founder and co-director of the Rock Center for Corporate Governance. My research has been published in the Harvard, Yale, and Stanford Law Reviews, and I have written on the regulation of accounting practices. I served as a Commissioner of the United States Securities and Exchange Commission from 1985 to 1990. Most relevant, perhaps, is my service on the audit committees of the boards of directors of three publicly traded corporations: Financial Engines, KKR, Inc., and Oracle Corp. Also relevant is the experience I have gained through interactions with thousands of directors of publicly traded corporations over the course of the twenty-four-year history of Stanford's Directors' College, a program I launched and continue to operate. My biography is attached as Exhibit A.

Simply put, auditor independence rules are essential for the proper functioning of an audit committee. As a member of an audit committee, with fiduciary obligations to the corporation's shareholders, I must be confident that the views expressed by the registrant's auditors are unbiased and reflect the auditor's best professional judgment. These rules must, however, be realistic. Rules that formalistically ascribe conflicts when there are none, or that fail to recognize that immaterial, or remote, or subjectively unknown relationships can safely be viewed as non-threatening to independence, do a disservice to the investors and audit committees that those rules are designed to protect. Independence rules that fail reasonably to adapt to changed economic realities and the evolution of technology will also impose unnecessary costs on shareholders and society by preventing efficient contracting and unnecessarily increasing compliance costs.

<u>The Loan Rule</u>.

Viewed from that perspective, I think it clear that the Commission's proposed amendments to the Loan Rule will improve its functionality in a manner that appropriately reflects the changed realities of the investment landscape. As the Commission observes, the investment marketplace today is in a constant state of flux. The growth of private equity firms, the creation of large investment funds, and increased M & A activity, all combine to cause constant, complex, and often opaque changes in ownership percentages and organizational structures.

[is] placed on economic reality."). See also *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 848 (1975) *quoting Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) ("form should be disregarded for substance and the emphasis should be on economic reality."); *International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel*, 439 U.S. 551, 558 (1970) (the Court looks to "the substance – the economic realities of the transaction – rather than the names that may have been employed by the parties.").

Lending institutions are often involved in these transactions and can acquire various interests. These interests can be managed by investment advisors who, in turn, operate large investment companies or LLP investment partnerships. Auditors can make good faith efforts to monitor this activity, but there is no comprehensive source of data that enables auditors to monitor lenders' investment relationships. Under these circumstances, the loan rule can lead to impractical outcomes.

Consider the example of the auditor of a global investment firm, a SEC registrant, who faced questions about its independence when the global investment firm decided to participate as a general partner of an LLP that manages multiple funds. One of these funds counts among its investments an 80% ownership stake in a portfolio company. The portfolio company entered into a joint venture with a major bank that was also a major lender to the audit firm. Given this lending relationship, independence of the audit firm may be impaired, notwithstanding the fact that the lending relationship was conducted in the course of ordinary business. This situation highlights a situation in which the Loan Rule's definition of "audit client" is so broad as to include remote entities that pose no threat to auditor independence. Indeed, from my perspective, a reasonable investor, understanding the transactions, would not view the lending relationship as impairing the audit firm's objectivity or impartiality.

<u>The Significant Influence Test</u>.

The Commission's Loan Rule proposal takes appropriate steps to narrow the definition of audit client and to clarify the restriction on loans from institutions so they apply only where there is significant influence on decisions at audit clients. The Commission's "significant influence" test can be extended to three additional areas, to help minimize impractical outcomes that risk stifling growth without any material contribution to auditor independence: *first*, it can help rationally cabin the expansive reach of the affiliate rule; *second*, it can realistically delineate the contours of the business relationship rule; and *third*, it can facilitate transition relief upon the occurrence of corporate events (such as merger or acquisition activity) to allow for an orderly, reasonable transition for existing relationships with accounting firms that are suddenly tainted as a result of the event.

<u>The Affiliate Rule</u>.

The expansive reach of the current definition of "affiliate of the audit client" creates a host of practical challenges in today's economy without any clear gain to independence. From my perspective, the most problematic aspect of the "affiliate" definition is the provision that treats commonly-controlled entities as affiliates of the audit client. Under this provision, when a public company is controlled by another entity, not only will the controlling entity be deemed an affiliate of the public company audit client, but also all other entities controlled by that controlling entity are viewed as affiliates of that audit client. This provision presents particular challenges for private equity firms. As the Commission is undoubtedly aware, the pace of private equity investment has expanded rapidly during the past two decades, and has fundamentally changed the way that capital is accessed and allocated. Merger and acquisition activity, as well as capital formation activity, is driven in significant part by private equity investment, and ownership structures of private equity funds and their portfolio companies are frequently in flux.

Against this backdrop, it is easy to see how the “commonly-controlled entities” element of the affiliate definition leads to compliance challenges and impractical outcomes. For example, if an auditor of a public company that is a portfolio company of a private equity firm also performs non-audit services for another portfolio company of that private equity firm that is audited by a different firm, and those services are not permissible under the independence rules, then the auditor’s independence could be jeopardized. This outcome can result even where the portfolio company is not material to the private equity firm. It is not apparent to me as an independent director, and chair of an audit committee, how the audit of the public company could reasonably be threatened by the non-audit services provided to the other portfolio company. These portfolio companies are not consolidated in any financial statements, and at the fund level are accounted for at fair value because the private equity firm qualifies for investment company accounting. Yet, in light of existing requirements, private equity firms and portfolio companies at the very least have to expend significant resources monitoring relationships with multiple accounting firms and providing extensive information to the firms on a frequent basis, not to mention the constraints placed on the private equity firms’ choice of service provider.

Merger and acquisition activity exacerbates these challenges. The acquisition of a new portfolio company by a private equity firm requires on-the-spot analysis of potential independence concerns. When a service or relationship is provided to the acquired entity that is impermissible, the service or relationship may have to be terminated or modified. That leads to additional costs as well as business disruptions in situations where the risk to independence is non-existent or, at most, extremely remote.

At the audit committee level, these relationships can result in extended dialogue to understand and assess the implications of these rules, even though there generally is no actual threat to the auditor’s ability objectively to perform the audit. I would encourage the Commission to revisit the common-control aspect of the affiliate definition so as to better align the application of the rules to organizational and transactional practices that are prevalent and that drive growth in today’s economy.

<u>The Business Relationship Rule</u>.

The reach of the business relationship rule, particularly when coupled with the definition of “affiliate of the audit client,” also leads to outcomes that inhibit growth while not meaningfully advancing investor protection. In today’s business environment, enterprises often collaborate on shared platforms, move processes to the cloud, and participate in networked ecosystems. The business relationship rule, however, can impair the extent to which collaboration in this environment can usefully rely on highly skilled and valued resources provided by accounting firms. This result can be inefficient and harmful to the shareholders whose interests are supposed to be protected by this rule.

For example, business consortiums composed of multiple enterprises sometimes turn to professional services firms, including accounting firms, for technical solutions in gathering, analyzing, and sharing data. Consider a business consortium formed to gather and analyze data from various health care providers. A professional services firm is engaged to help build the technology platform and analytics engine used by consortium members. If a participant in the consortium also happens to be an audit client of that same firm, the business relationship rule can have two adverse consequences. First, even though there are multiple parties in the consortium, and the audit client's use of data from the industry consortium seems unlikely to present any threat to the audit firm's independence, the consortium could not engage its preferred provider, the accounting firm, for the technology solution services because of the business relationship rule. Second, the audit client cannot use the information produced by the consortium in a way that might impact its financial statements, such as to set pricing or estimate rebates, even if management is completely responsible for those decisions.

Consider also the situation in which an auditor offers non-attest clients a subscription-based technology software solution. In keeping with marketplace dynamics, the auditor desires to transition the technology software solution to a cloud platform. A global technology provider offers an appropriate solution: a cloud platform that allows customers to place their own custom-built or third party applications in cloud infrastructure. Under Rule 2-01(c)(3) of SEC Regulation S-X, the auditor would be a consumer in the ordinary course of business. Standard customer agreements, using terms and conditions that apply to the technology provider's other customers, would govern the use of the cloud platform. There would be no joint marketing or co-branding of the software solution or the cloud platform between the auditor and the global technology provider. In this case, however, because the auditor has an attest relationship with the global technology provider, there is a need to clarify whether the auditor's independence would appear to be adversely affected by this routine service upgrade.

Similarly, if a company seeks to implement a new enterprise solution with components from multiple leading technology providers, the company may not be able to use a large, respected accounting firm as its system integrator if the large firms each have audit relationships with the technology providers. Although only tangentially related to the audit of any one of the technology providers, the company may be hindered in its ability to engage its systems integrator of choice because of these rules.

The Commission should actively consider modifications to the business relationship rule that would allow it to focus more clearly on relationships that pose a meaningful threat to the independence of the audit function. One aspect of the business relationship rule to consider in this regard is that the rule currently subjects relationships with investors in an audit client who are deemed substantial stockholders to examination. I would encourage the

Commission to consider aligning the business relationship rule with its proposed amendments to the Loan Rule, and to replace the substantial stockholder test with a significant influence test. My experience suggests that relationships with investors that have significant influence and a material interest are the types of relationships that should be evaluated for independence impacts, both in fact and appearance.

Transitional Relief.

Finally, I urge the Commission to consider a rule that allows for transitional relief when an independence issue arises due to corporate events beyond the accounting firm's control, such as a merger or acquisition. If, for example, an audit client acquires an entity that receives consulting services from an accounting firm that also audits the client, the company might have to terminate or modify the services if they are not permitted under the auditor independence requirements. In doing so, the company (or the acquired entity) may have to incur substantial costs and delays in terminating or modifying the relationship and in getting a new provider up to speed. Given these costs and the frequency with which these issues arise (particularly for private equity firms and companies that have active acquisition programs), it would seem reasonable to provide some type of transition period that allows companies a limited period of time to wind down or modify the relationship, or to limit the types of services that have to be terminated in the event of an acquisition.

Conclusion.

As the Commission acknowledges in its proposal, getting auditor independence right is critical to maintaining investor protections and promoting efficiency, competition, and capital formation. The Commission can and should do more to assure that the independence rules are consistent with the "economic realities" test applied by the Supreme Court, and that those rules look through formalistic definitions to focus on realistic concerns related to the audit function in modern capital markets.

Sincerely,

Joseph A. Grundfest

Joseph A. Grundfest

Exhibit A

JOSEPH A. GRUNDFEST

Joseph A. Grundfest is the William A. Franke Professor of Law and Business at Stanford Law School and Senior Faculty at the Rock Center on Corporate Governance at Stanford University. He joined Stanford's faculty in 1990 after having served for more than four years as a Commissioner of the United States Securities and Exchange Commission.

Professor Grundfest's scholarship in the areas of corporate law, securities regulation, and litigation has been published in the Harvard, Yale, and Stanford Law Reviews. The *National Law Journal* has listed Professor Grundfest among the nation’s 100 most influential attorneys; Directorship has listed him among the 100 most influential leaders in corporate governance; and *California Lawyer* has listed him among the top ten lawyers in California. Prior to joining the SEC, Professor Grundfest served as counsel and senior economist for legal and regulatory matters at the President's Council of Economic Advisors. An attorney and economist, Professor Grundfest practiced law with Wilmer, Cutler & Pickering, and was an economist with the Brookings Institution and the Rand Corporation.

Professor Grundfest’s bachelor's degree in economics is from Yale University (1973) and he completed the M.Sc. program in mathematical economics and econometrics at the London School of Economics (1972) (no degree awarded). His law degree is from Stanford (1978) where he also completed all requirements for an economics Ph.D. but for the dissertation (1978).

Professor Grundfest is founder and director of Directors’ College at Stanford Law School and principal investigator for Stanford Law School’s Securities Litigation Clearinghouse. He has served on the NYSE Legal Advisory Board, on the NASDAQ Legal Advisory Committee, on a rules committee of the United States District Court for the Northern District of California, on the SEC’s Advisory Committee on Improvements to Financial Reporting, and has been elected to membership in the American Law Institute. Professor Grundfest has been selected as a National Fellow by the Hoover Institution, and has been awarded a John M. Olin Faculty Fellowship. Professor Grundfest is admitted to practice in California and in the District of Columbia.

Professor Grundfest has twice received the John Bingham Hurlbut Award for Excellence in Teaching as well as the Associated Students of Stanford University award as the best professor at the Stanford Law, Business, and Medical Schools. Professor Grundfest is also co-founder and director of Financial Engines, Inc., and director and chair of the audit committee of KKR & Co. Inc. He chairs the board nominating committee of the NASDAQ Stock Market, and is a former director of Oracle Corp.