July 9, 2018

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

Via email to rule-comments@sec.gov

Re: File No. S7-10-18
Request for Comment on Proposed Rule for Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships

Ladies and Gentlemen:

This letter is submitted on behalf of the Financial Reporting Committee of the Association of the Bar of the City of New York. Our Committee includes a wide range of practitioners whose areas of interest and expertise include financial reporting under the securities laws and the regulation of the U.S. capital markets.

We are responding to the request of the Securities and Exchange Commission for comment on proposed amendments to Rule 2-01(c)(1)(ii)(A) (the “Loan Provision”) of Regulation S-X regarding auditor independence with respect to certain loan or debtor-creditor relationships. We applaud the Commission’s effort to undertake a review of the auditor independence requirements and to eliminate unnecessary or inefficient restrictions based on market experience.
We are generally supportive of the proposed amendments to the Loan Provision, which would: (i) focus the analysis solely on beneficial ownership, (ii) replace the existing 10 percent bright-line shareholder ownership test with a “significant influence” test, (iii) add a “known through reasonable inquiry” standard with respect to identifying beneficial owners of the audit client’s equity securities, and (iv) amend the definition of “audit client” for a fund under audit to exclude from the provision funds that otherwise would be considered “affiliates of the audit client.”

**Significant Influence Test**

We agree with the Commission’s proposal to replace the existing 10 percent bright-line test in the Loan Provision with a “significant influence” test similar to that referenced in other parts of the Commission’s auditor independence rules. We are concerned, however, that the proposed new test would require multiple layers of potentially conflicting analysis for significant influence and affiliate status, which we believe may lead to overly complicated and costly compliance.

The proposed amendment to the Loan Provision would provide that an auditor is not independent where “(1) Any loan (including any margin loan) to or from an audit client, or an audit client’s officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements. . . .” (emphasis added).

The proposing release states that “significant influence” is intended to be defined by reference to the principles in the Financial Accounting Standards Board’s ASC Topic 323, Investments – Equity Method and Joint Ventures (“ASC 323”). Under the proposed test, the ability to exercise significant influence would be based on the facts and circumstances of each case and could be indicated in several ways, including representation on the board of directors, participation in policy-making processes or material intra-entity transactions. In addition, 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 exercises significant influence over the audit client, absent predominant evidence to the contrary. Conversely, if the ownership percentage were less than 20 percent, there would be a rebuttable presumption that the lender does not have significant influence over the audit client, unless it could be demonstrated that the lender has the ability to exert significant influence over the audit client.

Existing Rule 2-01(f)(6) of Regulation S-X defines “audit client” in relevant part as an “entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client . . .”; and Rule 2-01(f)(4) of Regulation S-X defines “affiliate of the audit client” in part as an “entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client’s parents and subsidiaries. . . .”
Taking these provisions together, in order to determine whether any loan involving a beneficial owner of the audit client is covered by the Loan Provision, one would have to determine (i) whether such beneficial owner has “significant influence” over the audit client, which involves a facts and circumstances analysis as well as a 20 percent ownership analysis for purposes of the rebuttable presumption, and (ii) whether the transaction involves an “affiliate of the audit client” (which is included in the definition of audit client), which involves a control analysis, which is different from a significant influence analysis and which is interpreted by reference to a 10 percent ownership analysis in other contexts under the federal securities laws (e.g., Rule 10A-3(e)(1) under the Securities Exchange Act of 1934). By introducing a new standard and requiring multiple layers of overlapping and potentially conflicting analysis, the proposed amendment adds complexity and could create confusion and increase compliance costs.

To address the forgoing, we recommend that the Commission consider excluding affiliates from the definition of audit client for the purposes of the Loan Provision for all audit clients, not just fund audit clients, or consider other alternatives for eliminating this multi-layered analysis. The removal of this requirement would further the Commission’s purpose of promoting compliance with, and increasing the efficacy of, Rule 2-01. We note that the definition of “affiliate of the audit client” in Rule 2-01(f)(4) also includes both a significant influence test and a control test, and therefore could be susceptible to the same conflicting analysis.

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We thank you for the opportunity to comment on this important Commission initiative. Members of our committee would be happy to discuss any aspect of this letter with the Commission staff.

Respectfully submitted,

David S. Huntington
Chair, Financial Reporting Committee