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By email: rule-comments@sec.gov

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

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

Dear Office of the Secretary:

BDO USA, LLP appreciates the opportunity to respond to the Securities and Exchange Commission's ("Commission" or "SEC") Proposed Rule, *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationship* ("Proposed Rule").

We support the Commission's endeavor to address the significant challenges that auditors have been facing in complying with Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Provision" or "Rule"). We believe that the proposed revisions to the Rule will mitigate these challenges and enhance the effectiveness of the Loan Provision by focusing on only those lending relationships that could impair the auditor's objectivity and impartiality.

We have provided our views on the various components of the Proposed Rule below as well as our responses to your specific request for comments.

<u>Specific Request for Comments</u>

1. Focus the Analysis Solely on Beneficial Ownership

We support the Commission's proposal to focus the analysis on beneficial owners only and to delete the reference to record owners. We believe that any self-interest threats to independence created by an audit firm or a covered person's ("auditor") lending relationship with a record owner, who is not also the beneficial owner, would not impact an auditor's objectivity and impartiality. Specifically, record owners of an audit client's securities, such as broker-dealers or custodians, are holding such securities merely for the benefit of their customers and do not directly benefit from their holdings of the audit client's securities. Accordingly, such record owners would have little to no incentive to influence the auditor and the lending relationship would not impact the auditor's ability to remain objective and impartial with respect to the audit of the client.

We agree with the Commission that by revising the Loan Provision to only focus on the auditor's lending relationships with beneficial owners of the audit client's equity securities, the Loan Provision would effectively identify those shareholders who have a "special and influential role with the issuer" and therefore, would better capture those lending relationships that could pose potential threats to the auditor's independence.

2. *Significant Influence Test*

We support the Commission's proposal to revise the Loan Provision by replacing the 10 percent bright line test with a "significant influence" test. A bright line test using 10 percent of the audit client's equity securities may not always capture those shareholders who have a "special and influential role" as it does not take other factors into consideration that could lead to significant influence such as, service on the board of directors or the ability to set policy. Accordingly, it is feasible that a shareholder with less than 10 percent ownership could, through other means, have an influential role with the audit client. On the other hand, the 10 percent threshold could scope in shareholders who clearly could not exercise any level of influence over the audit client. We believe that using a "significant influence" threshold would more effectively identify those shareholders who have a "special and influential role" with the issuer and therefore, would better capture those lending relationships that could potentially compromise an auditor's independence.

We believe that the term "significant influence" as defined by ASC Topic 323, *Investments – Equity Method and Joint Ventures* is sufficiently clear and an appropriate standard for determining whether a beneficial owner can exercise significant influence over the audit client. We agree that auditors are already familiar with this definition as it is being applied to evaluate other independence matters such as whether an investor or investee would be considered to be an affiliate of an audit client.

3. *Known through Reasonable Inquiry*

We agree with the Commission and acknowledge that auditors face significant challenges in the application of the current Loan Provision due to the difficulty in accessing records and other information that disclose the beneficial ownership interests in an audit client. We therefore support the proposed revision that would incorporate a "known through reasonable inquiry" standard with respect to the identification of beneficial owners. We believe that this is a reasonable approach to address the challenges and recognizes that both the auditor and the client share responsibility for identifying all of the client's owners. We also agree with the Commission that if the auditor does not know, after reasonable inquiry, that one of its lenders is also a beneficial owner of the audit client's securities, it is unlikely that the lending relationship would create threats to the auditor's independence.

The Commission notes that the "known through reasonable inquiry" standard is generally consistent with regulations implementing the Investment Company Act, the Securities Act and the Exchange Act, and should therefore be a familiar concept for auditors. While auditors might be familiar with the concept, we believe it would be beneficial if the Commission provided further guidance as to what actions an auditor would be expected to take in order to meet the "reasonable inquiry" standard. Such guidance would help to ensure consistent application of the Loan Provision by the audit profession and issuer clients. This guidance might best be presented in a Staff Frequently Asked Question (FAQ) in order to present detailed examples. Also, the methods in which reasonable inquiries are made could change rapidly due to technological advances; therefore, a FAQ would appear to be most appropriate.

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

We support the Commission's proposal to revise the Loan Provision so that it would exclude "other funds that would be considered an affiliate of the audit client" where such funds are not audited by the firm. The expansive definition of an "affiliate of an audit client," especially as it relates to an investment company complex (ICC), has resulted in significant compliance challenges for audit firms due to the difficulty in determining investees of other funds when the firm is not also the auditor. We agree with the Commission that investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex and therefore the auditor should not be required to monitor and comply with the requirements of the Loan Provision with respect to these other funds.

The Proposed Rule, however, only excludes other affiliated *funds* within the ICC and therefore does not exclude other affiliated entities within the ICC such as the investment advisor and custodian. In cases where the auditor does not audit these other affiliated entities, we believe the same rationale would apply and therefore, recommend that they also be excluded from the definition of audit client.

Since the same challenges apply with other audit clients outside the ICC environment, we would encourage the Commission to consider applying this proposed enhancement more broadly to all audit clients by excluding those affiliates that are not audited by the firm from the definition of audit client for purposes of applying the Loan Provision to audit clients that are not part of an ICC. For example, under the Loan Provision as currently written, an audit firm (Firm A) would be deemed not to be independent of an audit client (Client A) if a Lender to Firm A has greater than a 10 percent ownership interest in a sister entity of Client A even if both the parent and sister entity are audited by another firm. In this situation, even if the Lender could exercise significant influence over the sister entity, it would not be able to exert influence over Client A and therefore, no threats to independence are created with respect to Firm A's audit of Client A. Applying this enhancement to all audit clients would promote consistency in application of the Loan Provision and would appear to be appropriate since the same threats to independence apply.

Finally, as discussed below under *The Breadth of the Definition of "Affiliate of the Audit Client,"* the challenges facing auditors of ICCs due to the all-encompassing definition of ICC extend beyond just the Loan Provision and impact the SEC's other independence rules. We therefore encourage the Commission to revisit the definition of ICC and revise it to include only those entities that could reasonably result in threats to an auditor's independence.

<u>Other Provisions Considered But Not Proposed</u>

Materiality

The Commission notes that the revisions to the Loan Provision do not include consideration of whether the ownership interest of the lender in the audit client is material to the lender or the audit client as it did not believe it was necessary to achieve its goal of "effectively and appropriately identifying lending relationships that could pose threats to auditor independence." The Commission, however, seeks input on this conclusion.

While we believe that replacing the bright line 10 percent ownership test with a significant influence test will better identify those shareholders who have a "special and influential role," we believe that unless the investment is material to the shareholder/lender, there would be little to no incentive to exercise influence over the auditor and any self-interest threats to the auditor's independence would be insignificant. We therefore believe a materiality factor should be incorporated into the Loan Provision whereby the Loan Provision would only apply when the beneficial owner has both significant influence and their ownership interest in the audit client is material to the beneficial owner.

We note that the definition of "affiliate of an audit client" includes an investor that has significant influence over the audit client but only if the investment is material to the investor. Accordingly, if a lender who is a beneficial owner of an audit client can exercise significant influence over the audit client, such lender would be considered an "affiliate of an audit client" if the investment were material.

If the Commission does not believe that the Loan Provision should only apply when the beneficial owner has both significant influence and their ownership interest in the audit client is material to them, we would recommend that the Commission consider including a materiality qualifier as it relates to whether the loan would be considered material to the auditor. Specifically, the lending relationship would only be prohibited if the beneficial owner had significant influence over the audit client and the loan was material to the firm or covered person. We believe that in cases where the lending relationship is not material to the auditor, the auditor's objectivity and impartiality could not reasonably be compromised.

Accounting Firms' "Covered Persons" and Immediate Family Members

The Commission has requested feedback on whether the definition of "covered person" for purposes of the Loan Provision or elsewhere in the auditor independence rules should be amended. We believe the Loan Provision should apply to all covered persons and their immediate family members. This treatment is consistent with the AICPA Code of Professional Conduct and most state boards of accountancy. In addition, we are not aware of other provisions within the Commission's independence rules that would warrant revision as it relates to the application of the covered persons definition.

The Commission has also requested feedback on whether there are any other types of loans made by a financial institution (under its normal lending procedures, terms and requirements) that should be permitted, similar to automobile loans and leases. We believe the Commission should permit other loans such as "student loans" and "home mortgages" (i.e., not just those for a primary residence) from a financial institution if obtained prior to the individual becoming a covered person with respect to the client or obtained prior to the financial institution becoming (or being acquired by) an audit client of the firm. Consistent with the AICPA independence rules, we also believe the Commission should consider permitting secured loans and loans that are immaterial to the covered person's net worth if obtained under the same circumstances. In all cases, the loans should be kept current regarding all terms and such terms should not change in any manner not provided for in the original agreement so long as the loan counterparty is a covered person. In addition, the estimated fair value of the collateral for the home mortgage should at least equal the outstanding balance during the term of the home mortgage and if not, the portion that exceeds the estimated fair value of the collateral should not be material to the covered person's net worth.

Evaluation of Compliance

We do not believe a requirement is necessary whereby loans or other financial relationships should be assessed at specific dates during the audit and professional engagement period, or the beginnings or ends of specific periods. We believe it would be impractical for the Commission to require specific dates or a specified approach due to the differences in firms' compliance systems and processes as well as the various types of audit clients within each firm. We believe firms should be responsible for determining how and when compliance is best assessed based on the relevant facts and circumstances.

Other Changes to the Commission's Auditor Independence Rules

We commend the Commission for being receptive to the need for other potential changes to its auditor independence rules. There are a number of existing rules that pose a significant challenge to firms with respect to monitoring and compliance and create minimal, if any, threats to auditor independence. We have identified such rules and respectfully request that the Commission consider appropriate revisions as discussed further below.

The Breadth of the Definition of "Affiliate of the Audit Client"

The definition of "affiliate of the audit client" has become increasingly burdensome for audit firms from both a monitoring and compliance perspective and captures entities whose relationships with the firm (and its professionals) pose no actual or perceived threat to independence with respect to the audit client. For example, the definition scopes in all entities that are under common control with the audit client regardless of whether the sister-entity or audit client is material to the parent entity. Accordingly, if a foreign network firm of the audit firm provided [de minimis] non-audit services, such as human resources services, to an immaterial sister entity (that was not an audit client), independence would be considered impaired even though neither company could exercise influence or control over the other. We believe such a relationship generally would have no bearing on the auditor's objectivity and impartiality nor would a reasonable investor with knowledge of all relevant facts and circumstances conclude that the auditor is not capable of exercising objective and impartial judgment on all issues encompassed within the audit engagement.

The definition of audit client also encompasses any entity that has control over the audit client (e.g., parent) even if such entity is not an audit client of the firm and the audit client is immaterial to the entity. Similar to immaterial sister entities that are not audit clients of the firm, we believe non-audit services provided by a network firm to a parent entity where the subsidiary audit client is immaterial to the parent, would generally not result in any actual or perceived threats to the audit firm's independence.

We believe the AICPA definition of "affiliate" (of a financial statement attest client) and the International Ethics Standards Board for Accountants (IESBA) definition of "related entity" (of an audit client) provide for a reasonable approach to capture those entities affiliated with an audit client that could create potential threats to auditor independence without resulting in a significant burden on audit firms, companies and their audit committee to monitor and comply with the independence requirements. Under the AICPA and IESBA approach, sister entities of the audit client are only scoped into the definition if the audit client and sister entity are material to the non-client parent entity. Similarly, materiality is considered for purposes of determining whether a non-client parent is considered to be an affiliate of the audit client (i.e., whether the audit client is material to the parent).

With respect to investment company complexes (ICC), the all-inclusive definition presents significant challenges outside the Loan Provision context. We believe the AICPA definition of an affiliate strikes a reasonable balance and therefore recommend that the Commission consider revising the definition to align with that of the AICPA. Where the audit client is a fund, the AICPA definition of affiliate includes investment advisers, general partners, and trustees of the fund if the fund is material[1] to those entities and they have either control or significant influence over the fund. As noted in our response in number 4. above, we do not believe other entities within the ICC that are not audit clients of the firm should be considered affiliates of the fund audit client. In cases where the auditor does not audit these other entities, we believe any threats created by relationships with such entities would be insignificant.

We strongly encourage the Commission to consider amending the affiliate definition to be consistent with that of the AICPA and IESBA. In addition to being a reasonable approach to capture those entities that could create potential threats to an auditor's independence (in fact and in appearance), we believe a uniform definition of affiliate within the audit profession will help to facilitate compliance with the Commission's independence requirements.

Finally, we believe it would be beneficial if the Commission were to clarify the definition of "control" as used in the definition of "affiliate of the audit client." Similar to the definition of "significant influence," we believe it would be appropriate to use the concept of "control" as defined in the accounting standards, namely, ASC 810, *Consolidation* as auditors are already familiar with the definition and its application. It would also have the added benefit of conforming to the AICPA definition of "control" and thus, result in consistent application of the control concept throughout the professional standards.

Safe Harbor Exception

The Commission's independence rules include a "safe harbor" provision in Rule 2-01(d) which applies in situations where the independence of a covered person is inadvertently impaired, provided that the violation is corrected promptly and the firm maintains an adequate quality-controls system. We would encourage the Commission to consider adding a similar safe harbor provision for inadvertent violations of the business relationships and non-audit services rules under Rules 2-01(c)(3) and (4) of Regulation S-X.

[1] For purpose of determining materiality, investments in, and fees received from, the fund are considered.

The restrictive nature and broad reach of the Commission's rules on non-audit services and business relationships create significant challenges for global network firms, especially when coupled with the challenges noted above concerning client affiliates. For example, a foreign network firm might inadvertently provide insignificant non-audit service to an affiliate of an audit client or enter into an immaterial business relationship with the affiliate. In most if not all cases, these technical violations have no impact on the audit engagement team's ability to remain objective and impartial with respect to the audit. Moreover, a reasonable investor with knowledge of all relevant facts and circumstances would not view such technical violations as adversely impacting the auditor's objectivity and impartiality.

We therefore recommend that the Commission expand the existing safe harbor provision in Rule 2-01(d) to cover inadvertent violations of the business relationships and non-audit services rules.

Transition to SEC Independence Rules

We recommend that the Commission consider including a provision that would allow a private company preparing for an IPO to transition from the independence standards governing the private company to the SEC's independence rules. Specifically, the auditors of a company preparing for an IPO are required to be independent under the SEC's independence rules for all periods included in the IPO filing. This requires the company (and auditor) to prepare years in advance to ensure compliance with the SEC's independence rules and often results in the company having to engage a new audit firm which is costly to companies and their shareholders.

To address this issue, we recommend that the Commission adopt an approach whereby independence would not be considered impaired provided the auditor is in compliance with the SEC independence rules for the most recent year included in the filing and in compliance with the AICPA independence rules and any other relevant standards (e.g., state board of accountancy independence rules) for the prior years included in the filing.

* * *

We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Christopher Tower, National Assurance Managing Partner – Audit Quality and Professional Practice at [redacted] or Lisa Snyder, National Assurance Managing Partner – Independence at [redacted].

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP

cc:

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