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March 4, 2020

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, DC 20549

**Re: File Reference No. S7-26-19**; Amendments to Rule 2-01, Qualifications of Accountants (SEC Release Nos. 33-10738; 34-87864; FR-86; IA-5422; IC-33737)

Dear Ms. Countryman:

We are pleased to respond to the request for public comment from the Securities and Exchange Commission (the "Commission") on the proposed rule, *Amendments to Rule 2-01, Qualifications of Accountants* (the "proposal").

## OVERALL COMMENTS

We share the Commission's long-standing view that an audit by an objective, impartial, and skilled professional contributes to both investor protection and market integrity, and, in turn, facilitates capital formation. Auditor independence is the very foundation of the auditing profession. It is both essential to investor confidence in financial reporting and critical for effective and functioning capital markets. We acknowledge and support the conceptual underpinnings of the auditor independence rules, which serve to ensure investors are provided with reliable financial reporting through high-quality audits performed by auditors who are capable of exercising objective and impartial judgment.

We support the Commission's decision to consider whether some of its rules remain relevant in the face of changes to the markets and those who participate in them. We appreciate that the Commission took into consideration feedback it received from the public through the rule-making process for the Loan Provision,[1] and its experience in administering the independence requirements since their initial adoption. This has resulted in a proposal that appropriately focuses on areas within the auditor independence rules that either have unintended consequences or involve significant practical challenges as a result of changing market conditions, without presenting any actual or perceived threat to objectivity and impartiality in the performance of an audit.

Therefore, we support the Commission's proposal, which will serve to more effectively focus the independence analysis on those relationships or services that are likely to threaten an auditor's objectivity and impartiality.[2]

[1] *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release 33–10648 (June 18, 2019) [84 FR 32040 (July 5, 2019)].

[2] *Amendments to Rule 2-01, Qualifications of Accountants*, Release 33–10738 (December 30, 2019) [85 FR 2332 (January 15, 2020)].

## EXECUTIVE SUMMARY

We have highlighted our observations and additional recommendations below. We believe these are largely requests for clarifications or recommendations which are logical extensions of certain elements of the Commission's proposal:

### i. Definitions of Affiliate of the Audit Client and the Investment Company Complex

- **Further alignment with the AICPA and IESBA affiliate definitions** – In addition to the proposed amendments, we recommend the Commission consider:
  - Adding a materiality qualifier to the entity under audit in the proposed affiliate definition in Rule 2-01(f)(4)(i)(B), such that a commonly controlled sister entity would only be deemed an affiliate when both the entity under audit and the sister entity are material to the controlling entity.
  - Bifurcating the proposed affiliate definition in Rule 2-01(f)(4)(i)(A) by adding a materiality qualifier to the entity that has control over the entity under audit, such that the upstream controlling entity would only be considered an affiliate when its investment in the entity under audit is material to the upstream controlling entity.
- **Assessing materiality** – In addition to the proposed amendments, we recommend the Commission consider:
  - Allowing companies and their auditors to follow the guidance the Commission provided in the recently adopted Loan Provision with respect to the significant influence analysis to satisfy the obligation to monitor materiality on an ongoing basis (i.e., the frequency and timing of the materiality assessment should be based on the specific facts and circumstances rather than specific dates, periods or transactions).
- **Application of the affiliate of the audit client and ICC definitions** – In addition to the proposed amendments, we recommend the Commission consider:
  - Clarifying that when the entity under audit is an operating company, the common control prong of the proposed affiliate definition Rule 2-01(f)(4)(i)(B) would only scope in other operating companies, such that a commonly controlled investment company, investment adviser or sponsor would not be considered an affiliate of the audit client operating company.
- **Codification of the "entity under audit" concept** – In addition to the proposed amendments, we recommend the Commission consider:
  - Including the term "entity under audit" in both the proposed affiliate definition in Rule 2-01(f)(4) and the proposed audit client definition in Rule 2-01(f)(6) to codify the "entity under audit" concept to further enhance consistency.

- Issuing additional guidance through Frequently Asked Questions from the staff ("FAQs") or other means to illustrate how the proposed definitions are intended to be applied under various scenarios involving different entities under audit within a corporate or private equity structure.

ii. **Business Relationship Rule** – In addition to the proposed amendments, we recommend the Commission consider:

- Adopting conforming amendments to align the business relationship rule with the Loan Provision to clarify that entities under common control with, or controlled by a beneficial owner of the audit client's equity securities that has significant influence over the audit client would be excluded from the scope of the business relationship rule.
- Promulgating its clarifying guidance regarding the entity under audit in an appropriate manner in the rule text for both the business relationship rule and Loan Provision in the adopting release or in a future FAQ.
- Regarding multi-company arrangements, undertaking a process to consider various fact patterns and provide clarifying guidance, through FAQs or similar avenues, to further assist auditors and registrants in reaching appropriate judgments in these situations.

iii. **Inadvertent Violations for Mergers and Acquisitions** – In addition to the proposed amendments, we recommend the Commission consider:

- Clarifying that the proposed transition framework is also applicable in situations where pre-existing services and relationships are identified shortly after closing and resolved as promptly as possible and no later than six months after closing.
- Clarifying that matters arising from a merger and acquisition transaction that are appropriately addressed pursuant to the proposed transition framework would not be considered independence violations or violations of any regulatory requirements of the Commission.

iv. **Loans or Debtor-Creditor Relationships** – In addition to the proposed amendments, we recommend the Commission consider:

- Exempting student loans obtained by a covered person's immediate family member.

We further discuss the above recommendations in the sections below.

## PROPOSED AMENDMENTS TO RULE 2-01, QUALIFICATIONS OF ACCOUNTANTS

We agree with the Commission that, in response to significant changes in the capital markets and the nature of its participants, amendments should be made to select aspects of its auditor independence requirements, particularly given that these requirements have not been updated since the passage of the Sarbanes-Oxley Act nearly two decades ago.[3] We believe the Commission's proposal appropriately focuses the independence rules and analyses such that relationships and services that do not pose threats to an auditor's objectivity and impartiality would not create independence violations. Such violations result in time-consuming audit committee review of non-substantive matters and may dilute the importance of more significant violations.

We support the Commission's emphasis on the significance of the application of the general standard of auditor independence in Rule 2-01(b).[4] As highlighted in the proposed introductory paragraph to Rule 2-01, "[t]he rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in §210.2-01(b)." Rule 2-01(b) states, in part:

> "[t]he Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."

Rule 2-01(b) further notes that "all relevant circumstances" should be considered in determining whether an auditor is independent. We believe Rule 2-01(b) sufficiently addresses facts and circumstances where an auditor's independence, both in fact and in appearance, may be compromised. We agree with the Commission that those relationships and services that might impact an auditor's independence under the general standard in Rule 2-01(b), individually or in the aggregate, generally would be easily known by the auditor and the audit client due to the nature, extent, relative importance, or other aspects of those relationships and services.[5]

## Definitions of Affiliate of the Audit Client and the Investment Company Complex

### *Further alignment with the AICPA and IESBA affiliate definitions*

We support the Commission's proposal to amend the affiliate of the audit client definition in Rule 2-01(f)(4) and the Investment Company Complex ("ICC") definition in Rule 2-01(f)(14) to address certain affiliate relationships, including entities under common control, by adding a materiality qualifier to commonly controlled sister entities. The proposed materiality qualifier is similar, in part, to the materiality evaluation for sister entities that currently exists in the definitions of "affiliate" in the American Institute of Certified Public Accountants *Code of Professional Conduct* ("the AICPA Code") and *The*

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[3] *Revision of the Commission's Auditor Independence Requirements*, Release No. 33–7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] and *Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 33–8183 (Jan. 28, 2003) [68 FR 6005 (Feb. 5, 2003)].

[4] 17 C.F.R. § 210.2-01(b).

[5] Release 33-10738, page 2334.

*Code of Ethics for Professional Accountants (including International Independence Standards)* ("the IESBA Code").[6]

As the Commission notes in the proposal, significant challenges exist in the practical application of the "common control" prong of the affiliate and ICC definitions, especially in the context of private equity firms and investment companies, where a high volume of acquisition and disposition activities could result in an expansive and constantly changing list of affiliates.[7] We also agree with the Commission that, in many instances, prohibited relationships or services with a commonly controlled sister entity do not result in a corresponding threat to an auditor's objectivity and impartiality, especially when such sister entity is not material to the controlling entity.[8] Consequently, we support the Commission's proposal to exclude these commonly controlled immaterial sister entities from the proposed affiliate definition in Rule 2-01(f)(4) and the proposed ICC definition in Rule 2-01(f)(14). We believe the amendments would better focus the attention of the audit firm, the company and the company's audit committee on relationships and services that are more likely to impair the auditor's objectivity and impartiality, and help to reduce the compliance costs and challenges associated with the application of the current affiliate of the audit client and ICC definitions. We also expect that the amendments will increase the choice of qualified audit firms and positively impact audit quality, without compromising independence.

The Commission notes in the proposal the amendments may not result in the same number of commonly controlled sister entities being considered affiliates as under the AICPA Code,[9] in part because, under the AICPA Code, a sister entity under common control would only be deemed an affiliate when both the entity under audit and the commonly controlled sister entity are material to the controlling entity. Based on our experience, typically, the entity under audit and the commonly controlled sister entity each has its own respective separate governance structure, and therefore, there is no mutuality of interest. Additionally, when the entity under audit is immaterial to the upstream controlling entity, we believe that the relationships and services the audit firm provides to or has with a commonly controlled sister entity and/or the controlling entity, generally would have no impact on the auditor's objectivity or impartiality with respect to the entity under audit. It is our view that, when the entity under audit is immaterial to the controlling entity, the financial results of the entity under audit would not have meaningful impact on the financial statements of the controlling entity. In such a case, it is unlikely that the controlling entity or the audit firm would consider the relationships and services between the audit firm and a sister company to have any influence over the audit firm's audit opinion and procedures with respect to the entity under audit. We believe that a reasonable investor with knowledge of all relevant facts and circumstances would also reach the same conclusion. Therefore, adding a materiality qualifier with respect to the entity under audit to the upstream controlling entity would better focus the

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[6] The AICPA Code, Definitions, 0.400.02(e) defines "affiliate" as "[a] sister entity of a financial statement attest client if the financial statement attest client and sister are each material to the entity that controls both" and the *IESBA Code* defines "related entity", in subsection (e) of the Glossary, Including List of Abbreviations as "[a]n entity which is under common control with the client (a "sister entity") if the sister entity and the client are both material to the entity that controls both the client and sister entity."

[7] Release 33-10738, page 2333.

[8] Release 33-10738, page 2333.

[9] Release 33-10738, see footnote 20 on page 2335.

audit firm, the company and the company's audit committee's attention on relationships and services that are more likely to impair the auditor's objectivity and impartiality.

Based on the above, we recommend that the Commission consider further alignment with the AICPA Code and the IESBA Code affiliate definitions to help reduce complexity and compliance challenges in applying the definitions. This could be achieved through two additional amendments. First, we recommend that the Commission consider adding a materiality qualifier to the entity under audit in the proposed affiliate definition in Rule 2-01(f)(4)(i)(B), such that a commonly controlled sister entity would only be deemed an affiliate when both the entity under audit and the sister entity are material to the controlling entity. Second, we recommend that the Commission bifurcate the proposed affiliate definition in Rule 2-01(f)(4)(i)(A) by adding a materiality qualifier to the entity that has control over the entity under audit, such that the upstream controlling entity would only be considered an affiliate when its investment in the entity under audit is material to the upstream controlling entity. We believe the inclusion of these two amendments in the rule would serve to further align the SEC independence requirements with the AICPA Code and the IESBA Code, and would enable companies and their auditors to apply a consistent affiliate evaluation and a harmonized global monitoring approach.

### *Assessing materiality*

As discussed above, the proposal to add a materiality qualifier to commonly controlled sister entities would help audit firms, companies and companies' audit committees to focus independence assessments on relationships and services that are more likely to create substantive threats to an auditor's objectivity and impartiality with respect to the entity under audit.

The concept of materiality has long been used in the financial statement preparation process and in the context of an audit of a company's financial statements or internal controls over financial reporting. SEC Staff Accounting Bulletin No. 99, *Materiality*, expresses the views of the Commission regarding how to assess materiality in preparing financial statements and performing audits of those financial statements.[10] Auditing Standard ("AS") 2105, *Consideration of Materiality in Planning and Performing an Audit*, of the auditing standards of the Public Company Accounting Oversight Board ("PCAOB") provides guidance on the auditor's consideration of materiality when planning and performing an audit of financial statements in accordance with the standards of the PCAOB.[11] PCAOB AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, instructs the auditors to use the same materiality considerations they would use for the audit of the financial statements.[12] Additionally, we note that in August 2018, the Financial Accounting Standards Board

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[10] SEC Staff Accounting Bulletin: No. 99 – *Materiality*. Footnote 1 states, in part, "This SAB is not intended to provide definitive guidance for assessing "materiality" in other contexts, such as evaluations of auditor independence, as other factors may apply." https://www.sec.gov/interps/account/sab99.htm

[11] PCAOB AS 2105. *Consideration of Materiality in Planning and Performing an Audit*. https://pcaobus.org/Standards/Auditing/Pages/AS2105.aspx

[12] PCAOB AS 2201. *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. https://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx

updated its conceptual framework to align its definition of materiality with the definition used by the SEC, PCAOB and AICPA. Based on these observations, we believe that sufficient guidance exists to apply the materiality concept and it is well understood by financial statement preparers, auditors, and sophisticated investors.

We also note that the current affiliate of the audit client definition in Rule 2-01(f)(4) includes a materiality evaluation requirement. The current prohibitions on financial and business relationships in Rule 2-01(c)(1) and Rule 2-01(c)(3) incorporate the materiality concept as well, such that auditors and their audit clients are familiar with materiality assessments in the context of auditor independence.[13] We believe audit firms and companies have sufficient knowledge and experience in assessing materiality considering both quantitative and qualitative factors for auditor independence purposes, based on existing financial reporting and auditing guidance, and their experience in applying the materiality concept since the adoption of the current rules about two decades ago. While such judgments can be complex, we believe audit firms and companies are capable of following general principles outlined in the available guidance, considering all facts and circumstances, and applying sound judgment to perform materiality evaluations properly.

Additionally, we believe that, as proposed, the focus of the materiality evaluation should be on whether the sister entity is material to the controlling entity. We do not believe it would be appropriate to, or necessary to, perform additional materiality evaluations regarding whether the sister entity is material to the entity under audit. In many cases, there are no investments in or transactions between the entity under audit and sister entities. Typically, the entity under audit would not be a party to, or a beneficiary of, the relationships with or services provided to sister entities. Accordingly, relationships and services the auditor may have with sister entities are generally irrelevant to the entity under audit. Therefore, we do not believe evaluating the materiality of sister entities in relation to the entity under audit would be relevant or appropriate in determining the sister entity's affiliate status. Consequently, we believe that, as proposed, the focus should be on evaluating the materiality of the commonly controlled sister entities with respect to the common controlling entity only.

We also do not believe it is necessary to include, within Rule 2-01(c), a requirement to aggregate sister entities in the materiality assessment for purposes of the affiliate analysis. We believe that the emphasis of Rule 2-01(b) on consideration of "all relevant facts and circumstances" sufficiently addresses additional threats to the auditor's objectivity and impartiality and any appearance issues that could arise in these situations.

However, given the significant challenges arising from the continuous evaluation and monitoring of materiality throughout the audit and professional engagement period, we recommend that the Commission consider clarifying that, if an entity is immaterial at the time of the initial assessment, the company and its auditor could satisfy their obligations to monitor materiality on an ongoing basis by reevaluating materiality in response to significant transactions, Commission filings, or other information that become known to the auditor, or the company, through reasonable inquiry. We believe that the frequency and timing of the materiality assessment should be based on the specific facts and

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[13] Release No. 33–7919, pages 76032 and 76042.

circumstances rather than specific dates, periods or transactions. This approach aligns with the guidance the Commission has provided in the recently adopted Loan Provision with respect to the significant influence analysis, and should reduce the compliance challenges of monitoring materiality on a continuous basis.[14] The Commission also noted in the Loan Provision that auditor independence is a shared responsibility between the audit firm and the audit client and that both parties should take responsibility for promoting the accuracy of information required to assess the auditor's independence.[15]

### *Application of the affiliate of the audit client and ICC definitions*

We agree with the Commission that, notwithstanding the fact that certain entities that are currently affiliates of the entity under audit would no longer be deemed affiliates under the proposed affiliate of the audit client and ICC definitions, relationships and services between the audit firm and these entities should still be evaluated under the general standard of auditor independence in Rule 2-01(b).[16] As noted by the Commission, relevant facts and circumstances should be taken into consideration and certain relationships and services with entities no longer deemed affiliates of the entity under audit, individually or in aggregate, could raise independence concerns. However, as acknowledged by the Commission, we believe that those relationships and services which would impact an auditor's independence generally would be easily known by the auditor and the audit client due to the nature, extent, relative importance or other aspects of the relationships or services.[17]

We support the Commission in proposing amendments to bifurcate the application of the affiliate definition and the ICC definition based on the type of entity under audit (i.e., whether such entity is (i) an operating company or (ii) an investment company, investment adviser or sponsor). We appreciate the Commission's clarification that auditors and companies should only apply the ICC definition in the proposed Rule 2-01(f)(14) to identify entities that are affiliates when the entity under audit is an investment company, investment adviser or sponsor. We also agree with the Commission that when the entity under audit is an operating company, even if it is controlled by an entity within the proposed ICC definition, auditors and companies should still look to the proposed affiliate definition in Rule 2-01(f)(4)(i)(A) through (D) to determine affiliates of the operating company. This will lead to more consistent independence analyses by auditors of these entities and appropriately reflect the fundamental differences in the business operations of investment companies, investment advisers, or sponsors from those of traditional 1934 Act issuers.

For the same reasons outlined above, and to increase both clarity and consistency in the application of the proposed affiliate and ICC definitions, we recommend that the Commission consider clarifying, as suggested in the proposal, that when the entity under audit is an operating company, the common control prong of the proposed affiliate definition Rule 2-01(f)(4)(i)(B) would only include other operating companies, and that a commonly controlled investment company, investment adviser, or sponsor would not be

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[14] Release 33–10648, page 32049.

[15] Release 33–10648, page 32049.

[16] Release 33-10738, page 2334.

[17] Release 33-10738, page 2335.

considered an affiliate of such operating company. For example, an unregistered fund, under common control with an entity under audit that is a manufacturing company, that is material to the common control parent, would not be considered an affiliate of the manufacturing company.

### *Codification of the "entity under audit" concept*

We support the Commission's proposed amendments with respect to other aspects of the affiliate of the audit client and ICC definitions that are not specifically discussed above; such as, explicitly defining investment companies to include unregistered funds; incorporating a significant influence prong in the proposed ICC definition in Rule 2-01(f)(14)(i)(E); and requiring evaluation of an investment company with respect to the controlling entity directly, even though the investment adviser to that investment company is not material to the controlling entity.

In addition, similar to how the Commission has specifically referred to "entity under audit" in the proposed ICC definition in Rule 2-01(f)(14)(i)(A), we recommend that the Commission consider including the term "entity under audit" in both the proposed affiliate definition in Rule 2-01(f)(4) and the proposed audit client definition in Rule 2-01(f)(6), to specifically codify this concept in the rule text and to further enhance consistency.

Further, given inherent complexities in the affiliate and ICC definitions, and the multiple changes the Commission has proposed making to different aspects of the ICC definition, we recommend that the Commission consider issuing additional guidance through FAQs or other means (such as diagrams) to illustrate how the proposed definitions are intended to be applied under various scenarios involving different entities under audit within a corporate or private equity structure.

## Business Relationship Rule

We support the proposal to align the business relationship rule in Rule 2-01(c)(3) with the Loan Provision by replacing the reference to "substantial stockholders" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client."[18] We believe that beneficial owners with significant influence, together with officers and directors, represent the appropriate population of persons in a decision-making capacity for purposes of the business relationship rule, similar to those who have "a special and influential role" with the audit client as that term is used in the Loan Provision. We also believe that the proposed amendment will provide clarity and greater consistency in identifying beneficial owners that are in a decision-making capacity over the audit client and therefore, better capture those business relationships that would impair an auditor's independence.

As the Commission notes, this will improve the rule by making it clearer and less complex, given "substantial stockholder" is not currently defined in Regulation S-X whereas the concept of beneficial owner with significant influence, as used in other parts

[18] Release 33-10738, page 2340.

of the Commission's independence rules,[19] is one with which audit firms and their clients are already familiar. This is especially the case given the additional clarifying guidance the Commission has provided in connection with the Loan Provision.[20] Consistent with the amended Loan Provision, the proposed amendment will also ease the compliance burden and help audit firms, companies and companies' audit committees to focus on those business relationships that are more likely to substantively threaten an auditor's objectivity and impartiality.

We appreciate the additional guidance the Commission has provided within the proposal directing auditors to focus on whether significant influence exists at the entity under audit when evaluating lending or business relationships with officers, directors or beneficial owners with significant influence over an affiliate of the entity under audit pursuant to the Loan Provision or the current or proposed business relationship rule.[21] We appreciate that the Commission took into consideration its consultation experience in connection with this portion of the business relationship rule as well as the implementation of the recently amended Loan Provision in providing this guidance. We agree with the Commission that the focus should be on those business relationships with persons in a decision-making capacity as it relates to the entity under audit.[22] We believe that this guidance will help auditors properly focus on relationships where conflicts or mutuality of interests may be present and could directly bear on and impact an auditor's objectivity and impartiality. We recommend that the Commission consider further promulgating this clarifying guidance regarding the entity under audit in an appropriate manner, such as in the rule text for both the business relationship rule and Loan Provision, the adopting release, or in a future FAQ, to ensure its accessibility in the future.

Additionally, we recommend that the Commission consider adopting conforming amendments to align the business relationship rule with the Loan Provision to clarify that entities that are under common control with, or controlled by, a beneficial owner of the audit client's equity securities that has significant influence over the audit client would be excluded from the scope of the business relationship rule. We understand that the Commission's long-standing position has been that beneficial ownership attributes upward to entities controlling the beneficial owner, but not back down to sister entities that are controlled by or under common control with the beneficial owner. This is acknowledged by the Commission in the adopting release for the Loan Provision, which states that "the Loan Provision can be implicated by lending relationships between an auditing firm and those that control the record or beneficial owner… (i.e., entities that are under common control with or controlled by the record or beneficial owner are not as such implicated by the Loan Provision)."[23]

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[19] 17 C.F.R. § 210.02-01(c)(1)(i)(E)(1)(i) and (ii), (c)(1)(i)(E)(2) and (3), and (f)(4)(ii) and (iii) and Release 33–10648, page 32040.

[20] Release 33-10738, page 2340.

[21] Release 33-10738, page 2341.

[22] Release 33-10738, page 2341.

[23] Release 33–10648, page 32045, Footnote 35 and *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships*, Release No. 33–10491 (May 2, 2018) [83 FR 20753 (May 8, 2018)], Footnote 22.

We believe that conforming this portion of the business relationship rule with the Loan Provision will further reduce complexity and help auditors and companies apply a consistent standard and approach when identifying and analyzing relationships with beneficial owners and appropriately focus on relationships that are more likely to impact an auditor's objectivity and impartiality. Further, we believe that attributing beneficial ownership upwards to entities controlling a beneficial owner but not back down to sister entities that are controlled by or under common control with such beneficial owner, is consistent with Section 13(d)-3 of the Exchange Act, *Determination of Beneficial Owner*. It does not appear that entities under common control with or controlled by the beneficial owner would be deemed beneficial owners of the entity under audit as they, in their own right, do not directly or indirectly, have or share the voting or investment power the beneficial owner has over the entity under audit.

### *Multi-company arrangements*

As the Commission noted in the proposal, it is more common today for companies to enter into multi-company arrangements in delivering products or services and that audit firms may contribute to such multi-company arrangements, such as through intellectual property or access to data using common technology platforms.[24] We believe that in many instances, an auditor's objectivity and impartiality are not impacted when both the audit client and its auditor are parties to or involved in such multi-company arrangements. The evaluation of permissibility in this situation would extend to both the impact to the audit client of the services provided as well as the application of the business relationship rule.

For example, a large retailer, which is not an audit client, engages an audit firm to develop and operate a blockchain-based system to allow certain of its vendors, none of which are an audit client of the audit firm, to bid on orders for goods in an "online marketplace." The primary purpose of the online marketplace is to allow the retailer to more efficiently manage its supply chain. Six months after the online marketplace's debut, the retailer decides to allow more vendors, some of which are audit clients of the audit firm, to participate and use the online marketplace. Further, the retailer decides to expand its online marketplace from a single sponsor platform to a collaborative network allowing other peer entities to manage their supply chain through the same online marketplace. As a result, one must analyze whether the audit firm could be viewed to have directly or indirectly provided prohibited services to, or be in business relationships with, audit clients that participate in the online marketplace.

In this scenario, so long as the facts and circumstances are appropriately assessed under the general standard of independence, we do not believe a threat is posed to the auditor's objectivity (and accordingly, no prohibited service or business relationship exists). Further, the retailer would incur significant expense to replace the audit firm in the multi-company arrangement in order to allow vendors or other peer entities audited by the audit firm to participate and mitigate the resulting business disruption. Since other vendors and peer entities may be audited by different audit firms, it could potentially be challenging for the retailer to identify a qualified service provider. This hampers the growth of business ecosystems, which we believe is fundamental to the growth of the United States economy.

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[24] Release 33-10738, page 2341.

In addition to a single sponsor platform such as we have described above, companies are increasingly forming collaborative networks which may be sponsored by multiple companies. Take for example, situations where the audit firm participates, through a contractual arrangement, with a diversified consortium of multiple participants that is formed and led by a non-audit client. Similar to the prior example, it would generally be reasonable to conclude that the audit firm's objectivity and impartiality should not be viewed as impaired if the audit firm participates at terms, conditions, pricing, and other requirements similar to those of other service providers, there is no exclusivity agreement which prohibits the audit firm and consortium participants from working with other marketplace competitors and the arrangement is not material to the audit firm. Where the audit firm reaches such a conclusion after considering all relevant facts and circumstances, and those charged with governance concur, the audit firm should not be deemed to have entered into a potentially impermissible, direct or indirect, business relationship with the consortium members or to have indirectly provided prohibited services to an audit client.

We recommend that the Commission undertake a process to consider fact patterns of this nature and provide clarifying guidance, through FAQs or similar avenues, to further assist auditors and registrants in reaching appropriate judgments in these situations. We would be pleased to provide additional examples for further consideration.

## Inadvertent Violations for Mergers and Acquisitions

We support the Commission's proposal of a transition framework to address inadvertent violations, resulting from merger and acquisition ("M&A") transactions, which would allow audit firms and their clients to transition out of impermissible relationships or services in an orderly manner and as promptly as possible. Merger and acquisition transactions are outside the control of the audit firm and it is unlikely that pre-existing relationships with, or services provided by, the audit firm to the counterparty or its affiliates would pose substantive threats to an auditor's objectivity and impartiality. Given the facts presented above, a reasonable investor, apprised of all relevant facts and circumstances, would perceive the audit firm as being objective and impartial with respect to its audit client. However, under the current rules, the audit firm must either terminate or restructure the pre-existing relationships and services prior to closing, or halt audit work mid-stream until the independence issues have been appropriately addressed. These sudden and inadvertent independence violations could potentially result in a delay of the transaction and/or impose serious and costly consequences for both the audit firm and their client. We believe that the proposal provides a practical approach for audit firms and their clients to address the potential challenges and detrimental impact presented by these situations.

As noted by the Commission, in most instances, potential independence issues resulting from M&A transactions should be identified and resolved before transaction closing. In situations where orderly transition cannot occur before closing, prohibited relationships and services should be corrected as promptly as possible and no later than six months after the effective date of the M&A transaction. We appreciate the Commission's efforts to align the length of the transition period with the current IESBA Code used to assess independence issues that arise in connection with M&A transactions, which would drive consistency and reduce compliance costs.[25] Additionally, we recommend that given the acquisitive nature of certain entities and the resulting perpetual changing landscape of their organizations, the Commission consider clarifying that the proposed transition framework could be applied in situations where pre-existing services and relationships are identified shortly after closing, and resolved as promptly as possible and no later than six months after closing.

We believe that the proposed criteria for the quality control requirements are sufficiently clear and no other criteria beyond the proposed Rule 2-01(e)(i), (ii) and (iii) are necessary. We also believe that these requirements should not increase compliance costs, as it is our understanding that firms generally should already have protocols established within their existing quality control system to identify and address these situations as promptly as possible. However, we recommend that the Commission consider clarifying that potential independence matters arising from an M&A transaction would not be considered independence violations or violations of any regulatory requirements of the Commission if the audit firm meets the three criteria outlined in the proposed framework.

We acknowledge that, in applying the general standard of auditor independence in Rule 2-01(b), the Commission has always required audit firms to focus on whether a relationship or the provision of a service would place the audit firm in the position of auditing its own work. We believe that the Commission's continued emphasis on the application of the general standard in Rule 2-01(b) to relationships and services not specifically addressed in Rule 2-01(c), and the general standard's focus on "all relevant circumstances", appropriately addresses any threat to an auditor's objectivity and impartiality in situations where inadvertent violations from M&A transactions involved relationships or services, which could potentially be subject to audit. Therefore, in response to the Commission's request for comment, we believe that it is appropriate to include prohibited relationships and services that may result in the auditor auditing its own work within the scope of the proposed M&A transition framework.

For M&A transactions that are in substance more like an initial public offering ("IPO"), such as when the legal acquirer is a public shell company, we believe it would be more reasonable to apply the proposed IPO lookback period amendments to these transactions, given that they present the same compliance challenges and the same threats to an auditor's objectivity and impartiality as other IPO transactions. As further discussed below, we believe the Commission's proposed amendments to Rule 2-01(f)(5)

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[25] *The IESBA Code*, April 2018, ''Mergers and Acquisitions'', pages 94-96.

appropriately mitigate the challenges associated with IPOs by shortening the lookback provision to the most recently completed fiscal year.

## Audit and Professional Engagement Period

We support the Commission's proposal to amend the audit and professional engagement period definition in Rule 2-01(f)(5) to shorten the IPO lookback period for all companies filing or required to file a registration statement with the Commission for the first time ("first-time filers") to the most recently completed fiscal year, provided that the first-time filer has been in full compliance with other applicable non-SEC independence standards in all prior periods covered by the registration statement filed with the Commission.[26]

Under current rules, a domestic company undergoing an IPO is required to engage an audit firm that has been independent under the Commission's rules for all years for which audited financial statements are included in the registration statement. This requirement could result in significant disruptions and additional transaction costs to the first-time filer,[27] as in situations where the company decides to pursue an IPO without requiring its auditor to follow the SEC independence requirements for the prior years, it may need to engage a new auditor to re-audit prior year financial statements, or even delay its IPO. This could potentially increase the time to market and distort economic decisions made by the company and prospective investors. Under the proposed rule, the existing disparate application of the audit and professional engagement period definition between first-time domestic and foreign private issuers would be eliminated. This would allow the audit firm and domestic issuers, similar to foreign private issuers, to focus the independence analysis on those relationships or services that exist in the prior year included in the filing. Generally, this period is the most relevant to investors and also the most likely to threaten an auditor's objectivity and impartiality. We concur with the Commission that shortening the lookback period for all first-time filers would help facilitate capital formation.[28]

Additionally, based on our own experience and consistent with the Commission's consultation experience, we believe the proposed requirements for domestic first-time filers to comply with other applicable non-SEC independence standards in all prior periods sufficiently mitigates any threats to the auditor's objectivity and impartiality associated with shortening the lookback provision for domestic first-time filers. Furthermore, we share the Commission's view that all relationships and services in prior periods should still be evaluated under the general standard of Rule 2-01(b), and these relationships and services, individually and in the aggregate, should be easily known due to the nature, extent, relative importance, or other aspects of the relationships or services.[29]

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[26] Release 33-10738, page 2338.

[27] Release 33-10738, page 2338.

[28] Release 33-10738, page 2338.

[29] Release 33-10738, page 2338-2339.

## Loans or Debtor-Creditor Relationships

We support the Commission's amendments to Rule 2-01(c)(1)(ii)(A)(1) and (E) to add certain student loans and de minimis consumer loans to the categorical exclusions from independence impairing lending relationships, recognizing that not all debtor or creditor relationships impact an auditor's objectivity and impartiality.[30]

Given that the Commission's current rules for financial interests apply equally to both covered persons and their immediate family members, we believe that the Commission's proposal to exempt student loans obtained for a covered person's educational expenses should also apply to student loans obtained by a covered person's immediate family member. The Commission expressed concern that the amount of student loan borrowings could be significant when considering student loans obtained for multiple immediate family members and thus could impact an auditor's objectivity and impartiality.[31] However, we believe that the overarching consideration of all relevant facts and circumstances related to the auditor's objectivity and impartiality, as required by Rule 2-01(b), is sufficient to mitigate any potential risk that a student loan obtained by an immediate family member may raise with respect to an evaluation of an auditor's independence.[32] Consequently, we do not believe an exception should be made to limit the application of this type of lending arrangement to only the covered person's educational expenses.

Furthermore, we do not believe the exception for student loans should be limited to loans incurred to fund only accounting and auditing educational expenses since there are many courses professionals may take to enhance their skillset, such as data analytics, statistics or business management. We have also seen professionals change their career paths and thus they may not have earned their primary degree in accounting or auditing. Additionally, we do not believe the Commission should adopt a dollar limit on the aggregate amount of educational expenses for which a professional or his or her immediate family members may incur loans since, under the proposed rule, these loans would still have to be obtained before the individual becomes a covered person in order to qualify for the exclusion, and as noted above, the auditor would be required to aggregate and evaluate all of these relationships under the general standard, Rule 2-01(b).

We also support the proposed modification to amend Rule 2-01(c)(1)(ii)(E), replacing "credit cards" with "consumer loans" and revising the provision to reference any consumer loan balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and available grace period.[33] Borrowers routinely incur various types of limited consumer financing for personal consumption which do not typically impair an auditor's objectivity and impartiality, even if the lender is an audit client.[34]

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[30] Release 33-10738, page 2339.

[31] Release 33-10738, page 2339.

[32] Release 33-10738, page 2339.

[33] Release 33-10738, page 2340.

[34] Release 33-10738, page 2340.

## Miscellaneous Updates

We agree with the Commission that the miscellaneous updates, as proposed, are appropriate and should be adopted and do not believe that any other conforming amendments are necessary considering these updates.

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We appreciate the opportunity to provide our perspectives on the current proposal. If you have any questions or would like to discuss our views further, please contact Ms. Shelley Duncan, Director of Independence, at +1 [redacted]

Sincerely,

Deloitte LLP

cc: Jay Clayton, Chair
Hester Peirce, Commissioner
Elad Roisman, Commissioner
Allison Lee, Commissioner
Sagar Teotia, Chief Accountant