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

**File No. S7-26-19**

**Amendments to Rule 2-01, Qualifications of Accountants**

**Release No. 33-10738; 34-87864; FR-86; IA-5422; IC-33737**

Dear Office of the Secretary:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or the Commission) request for comments on the Release for Amendments to Rule 2-01, Qualifications of Accountants (the Release or the Proposed Amendments). KPMG LLP fully supports the efforts of the Commission to codify certain staff consultations and modernize certain aspects of the auditor independence rules, and we welcome the opportunity to participate with the Commission, SEC staff, and other stakeholders in this process.

The Commission has requested public comment on the Proposed Amendments to Rule 2-01 in recognition that the existing auditor independence rules may not, in some situations, effectively focus the auditor independence analysis on those relationships or services that are likely to threaten an auditor's objectivity and impartiality.

**Overview**

We thank the Commission for its consideration of the amendments to Rule 2-01 in light of current market conditions and industry practices that may necessitate reform. Auditor independence is fundamental to audit quality and is essential to establishing confidence in an auditor's report on financial statements. We support the Commission's efforts to ensure the relevance of the auditor independence rules and to effectively focus the independence analysis on the relationships or services that are most likely to threaten an auditor's objectivity and impartiality.

Based on our experience, we believe that the Release's observations are well founded. In summary, we support the amendment proposed by the Commission to change the definition of "affiliate of the audit client." Because the definition of affiliate triggers the evaluation of services and relationships that bear on independence, we believe that the proposed amendment could be further enhanced by excluding sister entities from the definition of affiliate of the audit client when the entity under audit is not material to the common controlling entity. Services and relationships provided to sister entities are typically not relevant to the entity under audit when the entity under audit is not material to the common controlling entity and do not affect the objectivity or impartiality of the auditor, in fact or appearance.

We believe the Commission has appropriately identified the need for modification of the investment company complex definition. We believe the amendment suggested in the Release may create inconsistencies with other proposed provisions, because the modification of the investment company complex definition does not include a materiality qualifier for sister investment companies advised by sister investment adviser affiliates. Below, we suggest changes to the proposed definition of the investment company complex to exclude immaterial investment companies advised by investment adviser affiliates that are under common control with the investment company under audit or its investment adviser or sponsor. We also suggest changes to exclude certain sister operating companies that are controlled by the same investment adviser for investment companies under audit.

We support the proposal to add certain student loans to the categorical exclusions from independence-impairing lending relationships. We believe that the exception should not be limited to student loans of the covered person and that the exception should instead also include the covered person's immediate family (*e.g*., spouse/spousal equivalent and dependents). For the reasons described in our response, we do not believe extending this exception to a covered person's immediate family is likely to threaten an auditor's objectivity and impartiality.

We appreciate the Commission's proposal to introduce a transition framework to address the permissibility of services and relationships at new affiliates resulting from an audit client's mergers and acquisitions. We believe this framework will allow auditors and audit clients to appropriately address situations involving impermissible services and relationships between the auditor and a new affiliate, when an auditor's objectivity and impartiality are not actually impaired. We also ask the Commission to expand this proposed amendment by permitting companies and their audit firms to also utilize the transition framework when an impermissible service or relationship at a new affiliate is identified after the closing date of the merger, investment, or acquisition, but before the end of the transition grace period (*e.g.*, six months after closing date).

Finally, we believe it would be appropriate for the Commission to consider providing transitional guidance for companies that will be affected by the amendments.

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

**Questions Presented in the Response**

**II.A.1.a Proposed Amendments for Common Control and the Affiliate of the Audit Client**

1. *Should we add the materiality requirement, as proposed, so that only sister entities that are material to the controlling entity are deemed to be an affiliate of the audit client? Alternatively, should we retain the current common control provision in the affiliate of the audit client definition?*

We support the proposed amendment to the definition of "affiliate of the audit client" to include a materiality requirement with respect to operating companies under common control. It has been our experience, particularly in connection with independence evaluations for prospective SEC audit clients, that the services and relationships with sister entities under common control rarely impact the auditor's objectivity and impartiality in fact or appearance.

2. *Does the proposed amendment sufficiently focus the common control prong of the definition of affiliate of the audit client on those relationships and services that are most likely to threaten auditor objectivity and impartiality? Should we focus on the materiality of sister entities to the controlling entity, as proposed? If not, are there other amendments that would better focus on relationships and services that are more likely to threaten auditor objectivity and impartiality? For example, should we focus on whether sister entities are material to the entity under audit, in addition to whether they are material to the controlling entity? Should we consider aggregating sister entities in the materiality assessment rather than the assessment being done on an individual basis? Or is aggregation of multiple sister entities sufficiently covered by the general standard under Rule 2-01(b)?*

As noted above, we support the proposed amendment to the definition of affiliate of the audit client. While we agree that the proposed amendment improves the definition of affiliate of the audit client to focus on services and relationships that are most likely to threaten auditor objectivity and impartiality, we believe that the proposed amendment could be further improved by excluding sister entities from the definition of affiliate of the audit client when the entity under audit is not material to the common controlling entity. In our experience, the services and relationships at sister entities in this situation are typically not relevant to the entity under audit and do not affect the objectivity or impartiality of the auditor, in fact or appearance.

With the above modification, the proposed amendment would be consistent with the requirements of the AICPA's Professional Code of Conduct as it relates to sister entities under common control with the entity under audit, but would still require that the entities controlling the entity under audit be included in the definition of affiliate of the audit client.

We believe adding assessment of materiality of a sister entity to the entity under audit as an element of the affiliate definition would present an unnecessary complication, because existing concepts of financial materiality do not lend themselves to evaluation of sister entity relationships. Moreover, if one entity had a material investment in the other, the sister entity would be deemed an affiliate under existing and continuing independence standards. If the materiality of the relationship between the entities was based on other considerations (*e.g.*, a joint business relationship or shared services material to the entity under audit), we believe it would be appropriate to address under the general standard in Rule 2-01(b).

We do not believe it is appropriate to aggregate sister entities in the materiality assessment for affiliate determination because doing so would generally result in an inconsistent and arbitrary identification of entities meeting the definition of affiliate of the audit client. For example, it may not be practical to provide specific requirements or guidance that would be useful or relevant to the determination of which sister entities should be aggregated for purposes of affiliate determination. Additionally, the aggregation approach would likely not achieve the stated objective in the Release to exclude from consideration those services or relationships with immaterial sister entities that do not typically pose a threat to the auditor's objectivity and impartiality. We believe that the general standard in Rule 2-01(b), which requires the auditor to consider all relevant facts and circumstances is sufficient to address potential threats to the auditor's ability to be objective and impartial on all matters bearing on the auditor's independence.

3. *Would auditors and audit clients face challenges in applying the materiality concept in this context? Would auditors face particular challenges assessing materiality in connection with private portfolio companies? If so, what are those challenges and how could they be addressed?*

As observed in the Release, auditors and audit clients are currently required to apply a materiality concept to determine if any entity in a significant influence relationship with the entity under audit is an affiliate. Apart from the significant increase in the number of materiality assessments that will be required under the Proposed Amendments, we do not believe that the Proposed Amendments will impose different or more complex determinations in assessing materiality of private portfolio companies or other entities.

We do believe it would be helpful to auditors and audit clients if the SEC provides direction in the Release accompanying the final rules to clarify that materiality should be measured by utilizing relevant measures of controlling entities that are also reporting entities (*e.g.*, entities that prepare financial statements). Certain private equity firms are comprised of complex entity structures established for legal or other purposes that are not representative of the substantive management or operating structures. The materiality of sister entities to certain controlling entities established for non-operating purposes may not be relevant for purposes of the affiliate determination. Such entities typically do not have employees or operations and often do not prepare financial statements thus, it may not be possible or relevant to calculate materiality with respect to these non-reporting entities.

4. *Would focusing only on sister entities that are material to the controlling entity increase the risk that auditors will be performing audits when they are not objective and impartial? If so, is the overarching consideration of all relevant facts and circumstances, as required by Rule 2-01(b), sufficient to mitigate this risk? Would focusing on sister entities that are material to the controlling entity increase the risk of appearance issues?*

Although we agree with the observations in the Release that certain types of relationships or services provided to immaterial sister entities could impact the audit client or the auditor and thus threaten the auditor's objectivity or impartiality in performing its audits, to pose such a threat, these relationships typically would be significant and relevant to the entity under audit and thus known to the auditor or the entity under audit. Accordingly, we believe that the requirement to apply the general standard of independence in Rule 2-01(b) and consider all relevant facts and circumstances as required by Rule 2-01(b) is sufficient to mitigate any genuine risk that the auditor's objectivity or impartiality could be impaired by services and relationships with sister entities under common control with the entity under audit.

We also believe that the proposed amendments to the definition of audit client and definition of affiliate of the audit client reduce the risk that the auditor will not be objective and impartial in its audits because the proposed amendments will enhance the auditor's focus on those services and relationships that could pose actual or perceived threats to independence.

5. *Are there other types of affiliates that should be excluded from the definition because the services and relationships with such entities rarely threaten an auditor's objectivity and impartiality?*

As described in our response to the questions in item 2 above, we believe that the definition of affiliate of the audit client should be further amended to exclude sister entities when the entity under audit is not material to the common controlling entity. If that change is made to the final rule we do not believe there are other types of operating company entities that should be excluded from the definition of affiliate.

**II.A.1.b Proposed Amendments to the Investment Company Complex**

**II.A.1.b.i Entity Under Audit and Unregistered Funds**

6. *Should the proposed ICC definition specifically reference the entity under audit and explicitly define investment companies, for the purpose of proposed paragraph (f)(14), to include unregistered funds, as proposed?*

Yes. The proposed amendments to the definitions of audit client and the ICC will improve the clarity of the definitions and will promote consistent application of the definitions and related independence requirements.

7. *Is it appropriate to direct auditors of an investment adviser, sponsor, or investment company to the investment company complex definition, as we propose to amend it, to determine the entities that will be considered affiliates of the audit client? Why or why not? Would that lead to more consistent independence analyses by auditors of these entities?*

Yes, we believe use of the proposed ICC definition would be appropriate. Applying the definition of an affiliate of the audit client from the perspective of the entity under audit will help focus the independence analysis on those services and relationships that could reasonably impact the auditor's objectivity and impartiality with respect to audits of investment advisers, sponsors and investment companies.

We believe that additional changes to the ICC definition should be considered to improve the consistency and effectiveness of the proposed amendments. For example, we have observed that most investment advisers are private companies that are not required to file audited financial statements with the Commission, and we believe that the Commission should clarify the requirements of the proposed definition of investment company complex with respect to audits of investment advisers and sponsors. Specifically, we recommend that the amendment to the ICC definition provide that when the entity under audit *for SEC reporting or compliance purposes* is an investment company, investment adviser or sponsor, the auditor would focus solely on the definition of investment company complex to identify affiliates of the audit client.

We also note that proposed paragraph (f)(14)(i)(C) may have unintended consequences when an auditor audits a private fund for SEC Custody Rule compliance purposes. This provision appears to bring in any operating company that is controlled by or controlling any investment adviser or sponsor identified in paragraph (f)(14)(i)(B), including operating companies that are not engaged in asset management or asset management supporting services described in the investment company complex definition. Accordingly, we recommend that proposed paragraph (f)(14)(i)(C) be modified to exclude operating companies that are controlled by the investment adviser or sponsor identified in paragraph (f)(14)(i)(B) when the operating company is both (a) immaterial to the controlling entity and (b) not engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to an entity identified in proposed paragraph (f)(14)(i)(A) through (f)(14)(i)(B).

**II.A.1.b.ii Common Control with any Investment Company, Investment Adviser, or Sponsor**

8. *Should we include a materiality qualifier in Rule 2-01(f)(14)(i)(D), as proposed, so that only sister investment companies or investment advisers or sponsors that are material to the controlling entity are included in the proposed definition of ICC and, as a result, are deemed to be an affiliate of the audit client? Should we focus on whether sister investment companies, advisers, or sponsors are material to the investment company, adviser, or sponsor under audit, in addition to whether they are material to the controlling entity? Should we consider aggregating sister entities in the materiality assessment rather than the assessment being done on an individual basis? Or is aggregation of multiple sister entities sufficiently covered by the general standard under Rule 2-01(b)?*

We support the addition of the materiality qualifier to proposed Rule 2-01(f)(14)(i)(D) and note that this change will align with the proposed amendments to the definition of affiliate of the audit client for operating companies. Absent this proposed change, the affiliate rules with respect to sister entities would apply differently for operating companies compared to investment companies without any substantive distinction in relationships.

We do not believe it is necessary to further amend the definitions of affiliate of the audit client or investment company complex to include sister investment companies, advisers or sponsors if such sister entities are material to the entity under audit. If such entities are relevant to the entity under audit, we believe the definition of investment company complex, as proposed, will identify all such sister entities as components of the investment company complex and thus affiliates of the investment company, investment adviser, or sponsor under audit.

We do not believe it is appropriate to aggregate sister entities in the materiality assessment for affiliate determination because doing so would result in an inconsistent and arbitrary identification of entities meeting the definition of affiliate of the audit client. For example, it may not be possible to provide specific requirements or guidance that would be helpful in determining which sister entities should be aggregated for purposes of affiliate determination given the variety and complexity of ICC structures. Additionally, the aggregation approach would likely not achieve the stated objective of the proposed amendments to exclude from consideration those services or relationships with immaterial sister entities that do not typically pose a threat to the auditor's objectivity and impartiality. We believe that the general standard of independence in Rule 2-01(b), which requires the auditor to consider all relevant facts and circumstances is sufficient to address potential threats to the auditor's ability to be objective and impartial on all matters encompassed in its audits.

9. *Does the proposed amendment sufficiently focus the common control prong of the ICC definition on those services and relationships that are most likely to threaten auditor objectivity and impartiality? Should the analysis focus on the materiality of sister entities to the controlling entity, as proposed?*

Yes, we believe that the proposed amendment for entities under common control facilitates a sufficient level of focus on relationships between the auditor and the affiliates that are most likely to threaten auditor objectivity and impartiality. As noted elsewhere in our response, including our responses to questions 7 and 13, we believe that there are several additional changes that should be considered to further improve the focus on those services and relationships that could reasonably threaten auditor objectivity and impartiality.

10. *Would auditors and audit clients face challenges in applying the materiality concept in this context? Would auditors face particular challenges assessing materiality in connection with unregistered funds? If so, what are the challenges and how could they be addressed?*

Under the current definition of investment company complex, the auditor is not usually required to assess materiality of sister entities when identifying affiliates, and as a consequence of the proposed amendment, we believe that auditors and audit clients may face increased challenges in applying the materiality concept in the context of an investment company complex. For example, auditors may not have audit relationships with other entities in the investment company complex, including the controlling entity, and may find it difficult to obtain the information necessary to evaluate the materiality of sister entities to controlling entities in the ICC. Auditors may also experience difficulties in obtaining information regarding investments in unregistered funds and the existence and materiality of investments to controlling entities due to the lack of public disclosure requirements and confidentiality requirements associated with unregistered funds.

Data challenges similar to those described above exist today and could increase in volume and complexity under the proposed amendments. Such challenges might be addressed by auditors, the Commission and SEC registrants working together to define common and consistent practices and protocols for providing the information needed by auditors to maintain compliance with the SEC's independence rules.

11. *Would focusing only on sister entities that are material to the controlling entity increase the risk that auditors will be performing audits when they are not objective and impartial? If so, is the overarching consideration of all relevant facts and circumstances, as required by Rule 2-01(b), sufficient to mitigate this risk? Would focusing on sister entities that are material to the controlling entity increase the risk of appearance issues?*

Although we agree with the observations in the Release that certain types of relationships or services provided to immaterial sister entities could impact the audit client or the auditor and thus threaten the auditor's objectivity or impartiality in performing its audits, to pose such a threat, these relationships typically would be significant and relevant to the entity under audit and thus known to the auditor or the entity under audit. We believe that the requirement to apply the general standard of independence and consider all relevant facts and circumstances as required by Rule 2-01(b) is sufficient to mitigate any genuine risk that the auditor's objectivity or impartiality could be impaired by services and relationships with sister entities under common control in the investment company complex. We also believe that the proposed amendments to the definitions of affiliate of the audit client and investment company complex reduce the risk that the auditor will not be objective and impartial in its audits because the proposed amendments will enhance the auditor's focus on those services and relationships that could pose actual or apparent threats to independence.

12. *Is it appropriate for auditors to assess whether or not sister investment companies are material to the controlling entity even when a sister fund's investment adviser may not be material to the controlling entity? Should we include a reference to paragraph (f)(14)(i)(C) within paragraph (f)(14)(i)(D), as proposed?*

Yes, it is appropriate for auditors to assess whether or not sister investment companies are material to the controlling entity even when a sister fund's investment adviser may not be. This situation can occur when the investment adviser is not material to the controlling entity but the controlling entity holds an investment in the sister fund that is material to the controlling entity. While the proposed amendments to Rule 2-01(f)(14)(i) appear to include this requirement, additional guidance in the Release accompanying the final rules could be included to help ensure consistent application of the definition.

**II.A.1.b.iii Investment Companies that Share an Investment Adviser or Sponsor Included Within the ICC Definition**

13. *Should paragraph (f)(14)(i)(F) be adopted as proposed? Should we instead include a materiality qualifier for sister investment companies in proposed paragraph (f)(14)(i)(F)?*

We believe that modifications to proposed paragraph (f)(14)(i)(F) are necessary to be consistent with the stated intent of proposed amendments to the definitions of affiliate of the audit client and investment company complex. The Release notes that under proposed paragraph (f)(14)(i)(F), as part of its independence analysis, an auditor would need to consider sister investment companies that have the same investment adviser or sponsor as the investment company under audit regardless of whether such sister investment companies are material to the shared investment adviser or sponsor. We agree with this proposed requirement for sister investment companies that have the same investment adviser or sponsor as the entity under audit, in recognition that services and relationships with investment companies with the same investment adviser present greater threats to the appearance of the firm's independence than services and relationships with sister investment companies that have a different investment adviser.

The Release also notes that once an investment adviser is included within the proposed ICC definition (*e.g.*, any investment adviser affiliate), the investment companies it advises should be included as affiliates as well. With respect to investment companies advised by sister company investment advisers, this proposed provision appears to be inconsistent with the intent of the other proposed provisions that include a materiality qualifier for sister entity affiliates. Accordingly, we recommend that proposed paragraph (f)(14)(i)(F) be modified to remove the reference to (f)(14)(i)(D). Proposed paragraph (f)(14)(i)(D)(1) already includes in its definition of sister investment companies any investment adviser or sponsor unless the entity is not material to the controlling entity. Modifying proposed paragraph (f)(14)(i)(F) to remove the reference to proposed paragraph (f)(14)(i)(D) will continue to identify as an ICC affiliate of the entity under audit any sister investment company with the same investment adviser as the investment company under audit as well any investment company with an investment adviser or sponsor that controls or is controlled by the investment adviser for the investment company under audit. This suggested modification will eliminate from the definition of the investment company complex those immaterial investment companies advised by investment adviser affiliates that are under common control with the investment company under audit or its investment adviser or sponsor.

**II.A.1.b.iv Significant Influence within the ICC Definition**

14. *Should we incorporate a significant influence prong into the ICC definition, as proposed?*

Yes. We believe the amendments should include a significant influence provision in the ICC definition for the reasons described in the Release.

15. *Should we also adopt the proposed conforming amendment to Rule 2-01(f)(6) to include the reference to proposed paragraph (f)(14)(i)(E)?*

Yes. We believe the proposed conforming amendment to Rule 2-01(f)(6) is necessary to conform similar concepts and provisions in the existing rules for the change to the definition of investment company complex.

**II.A2. Proposed Amendment to Audit and Professional Engagement Period**

16. *We are proposing to amend rule 2-01(f)(5) to shorten the look-back period for all first-time filers to the most recently completed fiscal year, which would result in treating all first-time filers (including domestic issuers and FPIs) similarly for purposes of our independence requirements under Rule 2-01. Should we amend Rule 2-01(f)(5) as proposed? Alternatively, should we consider instead lengthening the lookback period for FPIs to all periods in which the financial statements are being audited or reviewed to harmonize the lookback periods?*

We support the proposal to amend Rule 2-01(f)(5) to apply the one-year lookback provision for issuers filing or required to file a registration statement or report to the Commission for the first time equally to domestic issuers and foreign private issuers. Consistent with the Commission's views, we believe this may eliminate any potential economic disadvantage of a domestic issuer as compared to a foreign private issuer resulting from application of the Commission's auditor independence rules applicable to the audit and professional engagement period. We believe the current limited lookback period for FPIs encourages capital formation and access to the U.S. capital markets and further believe that lengthening the lookback period could serve as a deterrent to capital formation in the U.S.

Additionally, we believe that the proposed requirement for a domestic company of full compliance with applicable independence standards in all prior periods covered by the registration statement, coupled with the requirement to further consider under the general standard of Rule 2-01(b) services and relationships that could reasonably be thought to bear on independence, sufficiently mitigates the risk associated with shortening the lookback provision for domestic first-time filers. It is our experience that services or relationships existing in prior periods that were permissible in accordance with the applicable independence standards generally do not impair an auditor's application of objective and impartial judgment on issues encompassed within the audits of the financial statements that will be included in the registration statement.

We observe that the proposal does not distinguish between issuers that maintained an audit relationship with the same audit firm for each of the years included in the registration statement (existing audit relationship), and those issuers that appointed an audit firm to concurrently audit each of the year's financial statements included in the registration statement (new audit relationship). We respectfully request that the Commission consider providing further clarification in the Release accompanying the final rules that the lookback period is one year, whether an existing or new audit relationship, so long as independence was maintained under the applicable standards for the earliest years presented in the registration statement.

**II.B. Proposed Amendments to Loans or Debtor-Creditor Relationships**

**II.B1. Proposed Amendment to Except Student Loans**

17. *We are proposing to except student loans obtained for a covered person's educational expenses that were not obtained while the covered person in the firm was a covered person. Should we adopt this new exception as proposed? Should we limit the proposed exception to student loans not obtained while the covered person in the firm was a covered person and to student loans obtained only for the individual's educational expenses (i.e., not the loans of immediate family members), as proposed?*

We agree with the proposal to except student loans obtained for a covered person's educational expenses that were not obtained while the individual was a covered person, including situations where a loan from a non-client was subsequently sold to an audit client or affiliate of an audit client while the individual was a covered person and the original terms remain in effect.

We do not believe, however, that the exception should be limited to student loans of the covered person, thus excluding from the exception loans of immediate family members. We believe that the impact on an auditor's objectivity and impartiality would remain low if the grandfathering of the student loans was extended to the immediate family of the covered person. The Release indicates as a rationale for the exclusion. "We are concerned that the amount of student loan borrowings could be significant when considering student loans obtained for multiple family members and thus could impact an auditor's objectivity and impartiality." However, the existing rules permit the holding of a mortgage loan (for a primary residence) acquired before the covered person became a covered person, which is the principle that the proposed amendment refers to as precedent for the "grandfathering" requirement of the proposed exception. A mortgage loan is typically larger than student loans, particularly in light of the various types of mortgage loans (*e.g.*, primary and secondary mortgages, home equity lines of credit) that are encompassed within the current rule. Although in the example of a mortgage loan, the risk of the lending relationship resulting in improper influence on the covered person may be mitigated by the lender's right of recourse to the collateral in an event of default, we would submit that the loss of a home would likely exceed the consequences the covered person would face in the event of a student loan default by an immediate family member.

We also note that the existing rules permit a covered person to obtain new automobile loans and leases without limitation in amount, number of automobiles, materiality, or the person or persons for whose benefit the loan or lease is undertaken. In sum, it appears the SEC previously determined that the amount of debt—whether one home financed by multiple loan products or multiple automobiles financed or leased—is not necessarily the deciding factor when it recognized "that not all creditor or debtor relationships threaten an auditor's objectivity and impartiality."

Additionally, the reasoning that is offered to support exclusion of immediate family members presumes that the covered person has an existing student loan, thus additional student loans held by immediate family members may cause the amount of student loan debt to surpass a threshold of "significance." In many cases, the covered person no longer owes student loan debt resulting from his or her own education, but may have obtained or cosigned a student loan associated with a spouse or dependent's education.

18. *Should all student loans be excepted from the application of the Loan Provision? Should the proposed exception include any other limitations, such as being limited only to the covered person's accounting and auditing educational expenses? Alternatively, should we expand the proposed exception to student loans of immediate family members? If we expand the exception to student loans of immediate family members, should we adopt a dollar limit on the aggregate amount of student loans that may be excepted? Is the overarching consideration of all relevant facts and circumstances related to the auditor's objectivity and impartiality, as required by Rule 2-01(b), sufficient to mitigate against any potential risk that student loans obtained for multiple immediate family members could be significant?*

We believe it is appropriate to except *all* student loans that were obtained when the covered person was not yet a covered person. We believe that unintended compliance challenges may exist if the exception only applies to the covered person's accounting and auditing educational expenses, or only for an education that is accounting and auditing focused. Further, a covered person may have a degree that is not related to accounting and auditing, but is relevant to his/her current profession (*e.g.*, an advisory or tax professional). Finally, we don't believe that any greater threat is posed to a covered person's objectivity or impartiality by a loan undertaken for non-accounting or non-auditing studies.

We support the Commission expanding the proposed exception to student loans of immediate family members, because we believe that threats to an auditor's impartiality and objectivity due to student loans held by immediate family members of a covered person are not significant and are no more significant as compared to principal residence mortgage loans of a covered person. A fixed limit on the amount of student loan debt would bear little or no relation to the individual's ability to repay, which is the basis for considering whether threats exist to the covered person's independence.

We believe that the general standard of independence under Rule 2-01(b) requires consideration of any threats to independence that could be presented by unusual circumstances involving student loan debt, obtained prior to an individual becoming a covered person, for the covered person or immediate family members' education.

19. *Should the proposed student loan exception include a limit on the amount that may be outstanding? If so, what is the appropriate amount?*

No, as with the other grandfathered loans, the protection against undue influence is inherent in the requirement to keep the loan current, taking into consideration payment due date and any available grace period.

**II.B2. Proposed Amendment to Clarify the Reference to "a Mortgage Loan"**

*20. Should we revise Rule 2-01(c)(1)(ii)(A)(1)(iv) to refer to "mortgage loans" instead of "mortgage loan," as proposed?*

We agree with the Commission regarding the need for revision to clarify the terminology in the rule concerning the types of loans intended to be included. While changing the reference from "mortgage loan" to "mortgage loans" provides more clarity, we suggest instead that terminology such as "home mortgage, equity, and similar loans related to a primary residence" is more precise. Certain loans encompassed within the rule, such as home equity lines of credit, are not considered mortgage loans; therefore, although such loans are collateralized by the home, it may not be understood that such loans are intended to be included.

**II.B3. Proposed Amendment to Revise the Credit Card Rule to Refer to "Consumer Loans"**

*21. We propose amending Rule 2-01(c)(1)(ii)(E) to replace "credit cards" with "consumer loans" and revise 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. Should we amend Rule 2-01(c)(1)(ii)(E), as proposed?*

We support the proposal to replace the term "credit cards" with "consumer loans." We believe that there are loans, aside from the extension of credit provided by credit cards, which are substantially similar to credit cards and, as such, should be treated consistently by the rule. We believe the proposed amendment would lessen the burden on covered persons who otherwise would not have the ability to utilize common marketplace financing options that are available to non-covered persons.

We do suggest that the Commission reconsider the $10,000 ceiling on the exception, which has remained unchanged for 20 years and reflects a substantial difference in value than when promulgated. We believe that a higher ceiling of credit balance, on a current basis as provided under the existing Rules, would not introduce a threat to the covered person's independence. We are not aware of a situation arising in our firm in which a breach of a rule due to a credit card or consumer loan was deemed to have impacted the objectivity or impartiality of an individual, engagement team, or the firm.

*22. Is the outstanding balance limit of $10,000 appropriate? If not, what would be a more appropriate limit?*

No. We suggest that the Commission reconsider the $10,000 ceiling on the exception, which has remained unchanged for 20 years and reflects a substantial difference in significance than when promulgated. Given rising salaries and changing practices in the use of credit cards, we do not believe an outstanding balance of $10,000 is a reasonable measure of potential threats to the impairment of a covered person's objectivity and impartiality. The credit or loan limit extended to an individual by the financial institution or vendor typically is tied to the individual's net worth (where relevant) and credit history. As such, provided that a covered person makes the minimum required payment by the due date or within any available grace period as provided under the existing rules, we believe that a higher ceiling would not introduce a threat to the covered person's independence.

*23. Is further guidance needed regarding how "current basis" applies for different types of consumer loans? If so, what additional guidance should we provide?*

No, we do not believe additional guidance is necessary, because the lender agreement will in all cases supply the criteria for the requirement to maintain the debt current.

*24. Is further guidance needed regarding the types of loans that would be considered "consumer loans" under the proposed amendment? If so, what additional guidance should we provide?*

Yes. Although the Release suggests that "consumer loans" would include the types of borrowings made for personal needs, a definition or additional guidance on what is intended to be covered by "consumer loans," or alternatively, what is not intended to be covered, would be valuable. For example, would a loan on a time-share property or boat fit within the exception? In addition, could overdraft protection at a financial institution fit within the exception? Additionally, it would be beneficial for the Commission to clarify whether other types of loans referred to above, such as home equity loans and student loans, to the extent they do not meet the criteria of the proposed exceptions, would be considered consumer loans and therefore alternatively subject to the consumer loan component of the proposed rule.

**II.C. Proposed Amendment to the Business Relationships Rule**

25. *Should we replace the reference to "substantial stockholders" in the Business Relationships Rule with the concept of beneficial owners with significant influence, as proposed? Would the proposed amendment make the rule more clear and reduce complexity, given that "substantial stockholder" is not currently defined in Regulation S-X? Alternatively, should substantial stockholder be defined? If so, how should we define it?*

Yes. We support the proposed amendment to replace the reference to "substantial stockholders" in the Business Relationships Rule with the concept of beneficial owners with significant influence over the entity under audit. Beneficial owners with significant influence over the entity under audit are parties with whom certain types of business relationships have the potential to threaten or impair the auditor's independence. Significant influence is a well-understood term that is used in other parts of Rule 2-01 of Regulation S-X and is consistent with the principles in ASC 323, *Investments – Equity Method and Joint Ventures*. The proposed amendment would make the rule more clear and reduce complexity, given that §240.13d–3, *Determination of Beneficial Owner,* provides guidance, and is well understood by issuers, investors, and audit firms. Additionally, the basis for this amendment was thoroughly developed in the Commission's consideration of the amendments to the Loan Provision of Regulation S-X.

26. *Would the proposed amendment result in more or fewer instances of business relationships that are prohibited by Rule 2-01(c)(3)? Does the concept of beneficial owners with significant influence, as proposed, more appropriately identify relationships that are likely to impair an auditor's objectivity and impartiality than the current rule?*

We believe that the proposed amendment would result in fewer instances of business relationships that are prohibited by Rule 2-01(c)(3), because the population of beneficial owners with significant influence over the entity under audit would be smaller than the population of substantial stockholders in the audit client. The concept of beneficial owners with significant influence over the entity under audit, as proposed and discussed in the Release, focuses the independence evaluation on the parties that could feasibly possess, by virtue of their relationship with the audit client, the ability to exercise significant influence over the audit firm, and consequently would introduce more precision to the identification of relationships that may impair an auditor's objectivity and impartiality.

27. *We understand that 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. Do these arrangements present instances where an auditor's objectivity and impartiality would not be impaired even after considering the proposed amendments discussed in this release? If so, what further amendments should be considered to appropriately focus on relationships where it is more likely an auditor's objectivity and impartiality would be impaired?*

We believe that the current rules, which require the identification and evaluation of indirect business relationships that are material to the auditor or audit client, coupled with the general standard in Rule 2-01(b), are sufficient to identify the types of relationships that could impair the objectivity or impartiality of the auditor in fact or appearance. Thus, we do not believe additional amendments are required. We would suggest additional guidance and encourage the Commission to give consideration to an audit firm's business relationships with non-audit clients. For example, we have observed an increasing number of circumstances in which an audit firm is one of a number of parties, including an audit client, contributing to a final work product or output. In these circumstances, additional guidance would be useful as it can be unclear whether there is a direct or indirect business relationship, calling for the application of a materiality threshold based on the contributions of each entity, including the audit firm, to determine if objectivity and impartiality would be impaired.

28. *Is the guidance related to "persons associated with the audit client in a decision-making capacity" and its application to the amended Loan Provision appropriate? Is further guidance needed to assist auditors and their clients in applying the recently amended Loan Provision and the proposed amendments? If so, what additional guidance is needed? Should we codify this guidance in our rules?*

The guidance in the Release provides that when an auditor is evaluating lending or business relationships with officers, directors or beneficial owners with significant influence over the audit client (*i.e*., "persons associated with the audit client in a decision-making capacity"), pursuant to the amended Loan Provision or the current or proposed Business Relationships Rule, the auditor should determine if the significant influence exists over the entity under audit. This guidance is clear as it relates to the application of both current and proposed rules in terms of whether the auditor complies or does not comply with the rules. To better align the words in the rule with the guidance discussed above, we believe that the Commission should consider codifying this guidance in the rules, or at a minimum carrying forward this guidance to the Release accompanying the final amendments to the rules.

**II.D. Proposed Amendments for Inadvertent Violations for Mergers and Acquisitions**

29. *Should we provide the transition framework to address inadvertent independence violations arising from mergers and acquisitions, as proposed? Should we expand the proposed framework to encompass IPOs? If so, would this eliminate the need for the proposed amendments in Section II.A.2? If we expand the proposed framework to encompass IPOs, are there additional criteria we should include in the quality control requirement? Are there other transactions that should be covered by the proposed framework?*

We agree that a transition framework should be included in the amended rules to address impermissible services and relationships at new affiliates arising as a result of mergers and acquisitions involving an audit client. Additionally, we agree with the observation in the Release that an expansion in auditor choices, which we believe would result from adoption of the transition framework, could promote better alignment of audit expertise with the audit engagement, leading to potential improvements in audit quality and financial statement quality. However, we believe that modifications to the proposed transition framework are necessary to achieve the primary objective of improving the focus of the independence analysis on those services and relationships that could reasonably impact the auditor's objectivity and impartiality. Accordingly, we suggest that the Commission clarify the proposed transition framework. The suggested changes would provide that impermissible services and relationships at new affiliates will not result in violations of the Rule 2-01(c) or other requirements, so long as the conditions in the transition framework are met and the services and relationships do not otherwise cause violations of the general standard of independence in Rule 2-01(b).

We believe that the transition framework should be applicable to all financial statement periods subject to compliance with Rule 2-01, as proposed in Section II.A.2. For example, if an entity anticipating an IPO were to make an acquisition in the year subject to the one-year lookback proposed in Rule 2-01, we believe the proposed transition framework should be applicable to such acquisition transaction.

We also support the Commission's amendments proposed in Section II.A.2 and agree that the challenges associated with mitigating independence compliance risks in IPO scenarios would be diminished by reducing the requirement for compliance with Rule 2-01 to the most recent preceding fiscal year. We believe the proposed amendments to Section II.A.2 and Section II.D are mutually exclusive and hence support adoption of both proposals.

We further believe consideration should be given to transactions in which the legal acquirer and accounting acquirer differ and that, in these instances, application of the transition framework should be available to both. Examples of such scenarios include reverse mergers in which the legal acquiree is deemed the "accounting acquirer" and in mergers of equals wherein one of the parties may be deemed the "surviving enterprise" and the other the "accounting acquirer." The application of the transition framework by an entity other than the legal acquirer in such transactions generally would be expected to result in application of the transition framework consistent with that of a "traditional" merger and acquisition transaction in which the registrant would apply the framework to entities it acquires.

30. *Are the proposed criteria for the quality control requirement sufficiently clear? If not, how could they be clarified?*

We support the principle that an auditor's quality control system should operate to provide reasonable assurance that there will be timely identification of material merger and acquisition transactions and potential violations resulting from such transactions. For example, some firms track their audit clients' Form 8-K filings announcing acquisition agreements to identify new affiliates of the audit client and perform independence evaluations of services and relationships prior to closing of the transaction. However, we also recognize that there can be instances in which a merger and acquisition transaction may not become known to the auditor prior to consummation of the transaction and thus not be subject to the auditor's system of quality controls until after the closing of a transaction. For example, an immaterial downstream foreign subsidiary of a large corporation makes an immaterial acquisition for which corporate management approval is not required. The transaction is not made known to corporate management prior to consummation, and consequently, the auditor will not have timely notice of the transaction, possibly resulting in the identification of an impermissible relationship after the transaction closing date. We believe application of the proposed framework in such instances would be appropriate. Accordingly, we respectfully request the Commission consider modifying the proposed amendments to the rules to clarify that impermissible services and relationships at new affiliates identified after closing of the transaction but otherwise meeting the conditions in the transition framework will not impair the audit firm's independence.

We also request that the Commission consider modifying the proposed amendments to the related quality control requirements by eliminating the provision regarding the identification of potential violations before the transaction (merger or acquisition) has occurred. The objective of a system of quality control is to identify and eliminate impermissible services and relationships with new affiliates of an audit client before such entities become affiliates upon closing of a transaction. However, the volume of transactions at certain entities such as those controlled by private equity groups, the immateriality of certain transactions, the lack of publicly available information about private transactions and the dependency on management of audit clients and affiliates for timely information are all external factors that can affect the ability of the audit firm to identify new affiliates and related services and relationships prior to closing of the transaction. We believe that by eliminating the requirement that the quality control system identify the potential violation before the transaction has occurred, the proposed quality control requirements related to transition provisions for mergers and acquisitions involving audit clients would be more effective at focusing the independence analysis on those services and relationships that are likely to threaten the auditor's objectivity and impartiality.

With respect to the proposed guidance below, we request the Commission consider our request for clarification of the underscored text:

> *"With respect to correction of the <u>independence violation</u> as promptly as possible, our expectation is that the <u>violation</u>, in most instances, <u>should and could be corrected</u> before the effective date of the merger or acquisition. However, we understand in some situations it might not be possible for the audit client and the auditor to transition the prohibited non-audit service or relationship in an orderly manner without causing significant disruption to the audit client."*

In relation to the use of the term "violation" in the text above, we note that a service or relationship identified prior to the close of a transaction that is otherwise permissible from the perspective of the relationship of the acquiree/service provider may not be permissible as of the effective date of the merger or acquisition. Such circumstances would not constitute a *current* violation, but would only result in a potential violation if that service or relationship extended after the close of the transaction. We request the Commission use alternative wording such as "potentially impermissible service or relationship."

Concerning the use of "should and could be corrected," we suggest the Commission consider replacing this phrase consistent with the language used by IESBA, which states, "*Non-assurance services currently in progress that are not permitted under this section for audit clients that are public interest entities are ended before or, if that is not possible, **as soon as practicable after**, the client becomes a public interest entity.*" We believe this would better align with the intention of the proposed framework, which we believe is intended to allow additional time for the orderly transition of a non-audit service or relationship, when the facts and circumstances warrant.

31. *Are there other criteria that should be added to the quality control requirement?*

We believe the quality control requirement should acknowledge the applicability of the general standard in Rule 2-01(b) with respect to the independence evaluation of the services and relationships associated with the new affiliate(s), both individually and in the aggregate, in considering the nature, extent, relative importance and other aspects of the services or relationships identified.

32. *Should certain prohibited services and relationships continue to be an independence violation regardless of the transition framework such as if the service or relationship results in the auditor auditing its own work?*

We believe that services or relationships that are or may become subject to audit could impair the auditor's independence regardless of the transition framework. However, there may be instances in which the auditor is providing a service to or has a relationship with an acquiree that is immaterial to the issuer, or is providing a service related to an immaterial financial statement element of the acquiree that would not be in the planned or actual scope for the performance of audit procedures. In such instances, we believe the transition framework should allow for the exercise of judgment by the auditor and registrant in the determination of whether or not the auditor would be placed in a position of auditing its own work and in determining the potential impact of such relationships or services on the auditor's objectivity and its ability to exercise impartial judgment. Other steps, such as retaining another service provider to reperform a service originally performed by the auditor that was prohibited by the independence rules, are also available to conclude that no violation of the independence rules has occurred.

33. *The proposed framework requires any independence violations resulting from a merger or acquisition to be corrected as promptly as possible. What is a reasonable period of time after the consummation of a merger or acquisition that would allow for an auditor to correct most types of violations covered by the proposed framework? Should the proposed amendments specify a maximum period of time for such corrections?*

We believe a six-month period, as described in the Release, constitutes a reasonable period of time to resolve most types of independence violations resulting from a merger or acquisition, and should be included in the Release guidance accompanying the final amendments to the rules.

34. *Should we exclude certain types of merger and acquisition transactions from the proposed transition framework? If so, what transactions should be excluded? For example, should the framework exclude transactions that are in substance more like an IPO, such as when the acquirer is a public shell company? In these situations, would it be more appropriate to apply the proposed amendments related to the look-back period for IPOs?*

No, we do not believe any transactions should be excluded from the proposed transition framework. However, we believe certain transactions warrant additional consideration regarding the application of the transition framework. For example, consider a transaction whereby a public shell company acquires a private operating company, and the auditor of the private operating company is requested to become the auditor of the new combined public entity upon the effective date of the transaction. In this fact pattern, it is not unusual for the private operating company auditor to also be requested to audit lookback periods of the private operating company under the standards of the PCAOB (and SEC independence Rules). As described, a preexisting relationship between the auditor and the private operating company exists, whereby services provided and permissible under a previous independence framework are no longer permissible under newly required SEC standards. We believe it would be appropriate and consistent with the Commission's stated objectives to afford the new combined public shell company and its auditor the ability to apply the transition framework, as the auditor of the private operating company is being requested to become the "new auditor" of the public shell company, including the private operating company.

It does not appear that under the proposed amendment the auditor of the combined public entity (inclusive of the operating company) would be afforded the transition guidance because prior to the close of the acquisition, the auditor was not the auditor of the public shell company. In this scenario, we believe application of the transition framework by the public shell company alone to its acquisition of the private operating company may not result in achievement of the objectives of the proposed amendments, as the transaction may give rise to inadvertent auditor independence violations at the private operating company. As described in our response to Question 29, we believe consideration should be given to transactions in which the legal acquirer and accounting acquirer differ and that in these instances, application of the transition framework should be available to both. Further, it may be appropriate for both entities to utilize the transition framework, as application of the transition framework by the public shell company could serve to benefit both audit firms and issuers by encouraging a larger pool of eligible auditors and create less potential disruption to issuers if the public shell company was permitted to apply the transition framework.

While our recommendation for merger and acquisition transactions offers relief to entities in the current year that diverges from the relief available to IPOs in the current year, we believe this treatment is appropriate for situations involving mergers and acquisitions because the timing of mergers and acquisitions is generally shorter and more uncertain than IPO transactions.

We further believe that application to the operating company of the proposed lookback period in Section II.A.2 would be appropriate. We suggest that the Commission in its adopting Release provide additional guidance in the application of the proposal to this example and similarly structured transactions.

## II.E. Proposed Amendments for Miscellaneous Updates

*35. Should we make the miscellaneous updates described above? Are there other conforming amendments we should make in light of these updates?*

Yes. We agree that the proposed amendments for miscellaneous updates should be made for the reasons stated in the Release. However, we believe it is important that the Release accompanying the final rules repeat the assertion that the proposed amendment to Preliminary Note to Rule 2-01 and the Introductory text to Rule 2-01 do not affect the application of the auditor independence rules. More specifically, emphasis should be included in the Release accompanying the final rules that the factors described in paragraph 2 of the Preliminary Note remain general guidance only with their application dependent on the particular facts and circumstances, as currently described in the Preliminary Note to Rule 2-01.

*We respectfully ask the Commission to consider these additional observations:*

*Transition guidance*

We think it would be appropriate for the Commission to consider providing transitional guidance for companies that will be affected by the amendments. We provide two scenarios below that illustrate some of the challenges a company could face when adopting the proposed amendments.

The proposed amendments to the affiliate definition in Rule 2-01 do not include any provisions for companies that will be impacted by the change to the affiliate definitions in the year the amended rule is adopted and effective. We believe the Commission should consider providing transitional guidance for companies that will present audit period(s) that straddle the effective date of the amended rule in a registration statement. For example, in a case where a new issuer appoints a new auditor subsequent to the rule becoming effective, immaterial sister entities would no longer be considered affiliates after the effective date of the rule. However, for the portion of the audit period(s) presented that precedes the rule change, those same entities may qualify as affiliates under the prior rule. Because the independence evaluation for new issuers is a lookback, we believe it would be appropriate to allow companies and their auditors to apply the amended definition of affiliate retroactively to the full year presented.

The proposed amendments to Rule 2-01 to address challenges that may result from a merger or acquisition transaction do not include provisions applicable to situations in which companies experience a merger or acquisition shortly before the effective date of the proposed rule, and the transaction is not discovered until shortly after the effective date (all within the proposed six-month transition period). We request the Commission consider providing transition guidance that would address the aforementioned situation, and that such guidance permit companies to apply the transition framework to a merger or acquisition that occurred before the effective date but was identified after the effective date of the amended rule, so long as they otherwise meet the quality control requirements and correct any independence violations resulting from the merger or acquisition within the proposed six-month timeframe.

*Guidance re: "office of the lead audit engagement partner" within "covered persons" definition:*

We respectfully suggest the Commission provide additional guidance considering the relationship of other partners' proximity to the lead partner as a threat to the auditor's independence, given the current work environment with expanding technology, virtual "offices", and telecommuting capabilities that have changed the regular personal interactions between individuals in a physical office.

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We appreciate the opportunity to respond to the Proposed Amendments.

Very truly yours,

KPMG LLP

cc:

SEC

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