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March 13, 2020

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

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

Dear Ms. Countryman:

Ernst & Young LLP (EY, we or our) is pleased to provide comments to the Securities and Exchange Commission (SEC or Commission) on its proposal to amend and modernize the auditor independence framework to more effectively focus the independence analysis on those relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality (proposed amendments or proposal).

We appreciate the efforts of the Commission and its staff to update and improve the effectiveness of the auditor independence rules. We believe that each of the proposed amendments will further investor protection by appropriately directing the focus of the independence rules to those situations where auditor independence may be impaired, while reducing unnecessary evaluation of situations that do not pose a reasonable threat to independence.

Independence in fact, and in appearance, is central to who we are and to our ability to properly discharge our role as an auditor. The independence of auditors from management and companies being audited underpins confidence in financial reporting. Independence facilitates objectivity and the use of impartial judgment in conducting audits. The Commission's independence rules help ensure auditor independence by identifying certain relationships between the auditor and the entity being audited that impair an auditor's independence in fact or appearance. This enhances both investor protection and market integrity, which, in turn, facilitates capital formation.

In this letter, we have responded to the Commission's questions regarding the proposed amendments and have provided observations and suggestions that we believe will either help clarify the proposed amendments, or further enhance the proposed amendments to better achieve the objective of focusing the independence rules on those relationships or services that are more likely to pose threats to independence. We have also provided comments on a few related matters for the Commission's consideration at the end of this letter.

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## A. Proposed Amendments to Definitions

***Proposed Amendments to 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?*

   **Response:**

   We agree that the current definition of "affiliate of the audit client" should include a materiality test for sister entities of the audit client for the reasons set forth by the Commission in the discussion of the proposed amendments.

   The proposed amendments would amend the definition of affiliate of the audit client to require the sister entity to be material to the controlling entity for the sister entity to be identified as an affiliate. However, the proposed amendments would not also require the entity under audit to be material to the common controlling entity, as required by both the American Institute of Certified Public Accountants (AICPA) and the International Ethics Standards Board for Accountants (IESBA) in their ethics and independence rules. The Commission's discussion of the proposed amendments acknowledges this inconsistency and states that the Commission concluded that requiring materiality between the entity under audit and the controlling entity may exclude from the proposed definition of an affiliate sister entities when relationships with, or services from, an auditor would impair objectivity and impartiality. Consistent with the conclusions of the AICPA and IESBA, we believe that, when the entity under audit is immaterial to the controlling entity, relationships with, or services to, a sister entity generally do not impair the auditor's objectivity and impartiality (in fact or appearance). In situations when the facts or circumstances indicate that services or relationships between the auditor and a non-affiliate sister entity to the entity under audit impair the auditor's objectivity and impartiality, the general standard in Rule 2-01(b) would be sufficient to disallow providing the service or establishing the relationship. Accordingly, we recommend that the affiliate of the audit client definition in Rule 2-01(f) be amended to include sister entities only when both the sister entity and the entity under audit are material to the controlling entity. By making this additional change, the Commission's definition of affiliated sister entities would be aligned with long-standing international ethics and independence standards that have served investors well in providing the necessary protection to maintain auditor independence, thereby realizing to a greater extent the benefits of international consistency for this important determination of the affiliates of the entity under audit.

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)?*

**Response:**

We agree that the proposed amendment will better 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. As discussed in our response to Question 1, we believe that the proposed amendment to the affiliate definition as it relates to sister entities would better achieve the intended objectives by also requiring the entity under audit to be material to the common controlling entity.

We do not believe the amendments to the definition of affiliate of the audit client in Rule 2-01(f) should require the aggregation of sister entities in the materiality assessment. Generally, sister entities that are not part of the entity under audit are not operationally and financially interdependent, and, accordingly, aggregating sister entities when applying the materiality test would not achieve the Commission's stated objective of identifying those relationships or services that present issues with respect to the audit firm's objectivity or impartiality. For example, if aggregation was required, the extensive number of unrelated portfolio companies identified as affiliates of the entity under audit in private equity structures would not be reduced, essentially leading to the same result as the current definition of sister entities that are affiliates. We agree that the application of the general standard under Rule 2-01(b) would sufficiently address facts and circumstances where aggregation of multiple sister entities is appropriate in applying the materiality test (e.g., the sister entities are legally separate but have the same management and material intercompany transactions support their operations).

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?*

**Response:**

We believe that auditors and audit clients will generally be able to manage challenges in applying the materiality concept outlined in the proposed amendments. As the proposal states, the concept of materiality as it relates to sister entities is consistent in part with the independence standards of the AICPA. Auditors also evaluate the materiality of sister entities when determining affiliates under the international independence standards issued by IESBA (IESBA code). Materiality assessments are also currently required for other entities within the affiliate definition (e.g., an entity that has significant influence over the audit client).

Our experience is that obtaining the necessary information needed to make materiality evaluations of other entities not audited by the auditor can, in some situations, be challenging (e.g., the auditor audits a portfolio company of a private equity fund, but not the fund). However, auditors generally have engagement agreements with audit clients that require their assistance in making these evaluations and should be able to develop and implement sufficient procedures to support the necessary evaluations.

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?*

**Response:**

For the reasons stated in our response to Question 1, we do not believe that focusing only on sister entities that are material to the controlling entity will unduly increase the risk that auditors will be performing audits when they are not objective and impartial. In fact, by clearly delineating between material and immaterial entities, we believe that the auditor and the audit client will rightly focus attention on services and relationships that could reasonably have an impact upon the impartiality and objectivity of the auditor. We agree that, in situations when the facts or circumstances indicate that services or relationships that involve sister entities would impair the auditor's objectivity and impartiality (in fact or appearance), the general standard in Rule 2-01(b) would disallow providing the service or establishing the relationship.

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?*

**Response:**

The proposed amendments to address sister affiliates, after considering our response in Question 1 to also require the entity under audit to be material to the common controlling entity, will sufficiently focus the affiliate definition on those entities that are relevant to assessing the auditor's objectivity and impartiality. There are no other types of potential affiliates that should be excluded from the definition of an affiliate of the audit client.

However, we believe the proposed changes to Rule 2-01(f)(4)(ii), which address the investment company complex (ICC), require clarification. Specifically, when the entity under audit is an issuer that is not an investment company, an investment adviser or sponsor, it is not clear whether registered funds managed by a subsidiary of that entity would be affiliates of such issuer. Registered funds generally have independent boards that control the funds' operations and hire an investment adviser to provide investment advisory services under the boards' direction and oversight. Given the board's responsibilities, one might conclude that the investment adviser does not control the fund. If the adviser does not control the fund, under the proposed amendments, the fund would not be an affiliate of such issuer under any of the prongs of Rule 2-01(f)(4). However, if the fund is the entity under audit, such issuer would be an affiliate through application of the ICC definition in Rule 2-01(f)(14). To provide clarity and avoid inconsistency in the application of the affiliate rule, we recommend that the Commission address this apparent oversight.

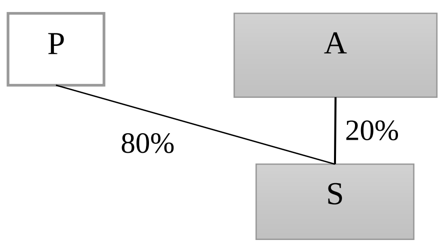
We would also like to further comment on the definition of affiliate of the audit client. Specifically, in the discussion of its proposed amendments, the Commission in footnote 11 defined the term "entity under audit," since it was necessary for readers to understand that term in evaluating how affiliates are determined under the current rules and proposed amendments. We believe that the Commission could significantly improve the clarity and consistency of the application of its *Definition of terms* in Rule 2-01(f) by defining the term "entity under audit" and using that term in place of "audit client" when it is not intended to include all the entities within the definition of audit client in applying the Commission's independence rules. For example, the Commission, in both the current rule and the proposed amended rule, defines affiliate of the audit client to include an entity "… that has control over the <u>audit client</u> or over which the <u>audit client</u> has control …." (emphasis added). The term "audit client" is defined as "… the entity whose financial statements or other information is being audited, reviewed, or attested to and any <u>affiliates of the audit client</u> …." (emphasis added). By using the term "audit client" in the definition of affiliate of the audit client, rather than the term "entity under audit," confusion and improper literal interpretations result. Consider the following example:

- Entity A, the entity under audit, has a 20% equity interest in Entity S and has significant influence over Entity S.

- Entity S is material to Entity A.

- Entity P has an 80% interest in Entity S and controls Entity S.

- Entity P has no equity interests in Entity A and does not exercise significant influence over Entity A.




In this example, Entity S is an affiliate of Entity A. Further, a literal application of the definition of affiliate of the audit client results in Entity P also being designated as an affiliate of Entity A, since Entity P controls one of the entities within the definition of "audit client" (Entity S). However, the Commission, in the application of its rules, does not consider Entity P to be an affiliate of Entity A, the entity under audit. We recommend that the Commission define the term "entity under audit" in Rule 2-01(f) and use that term to properly designate those entities that are affiliates of the entity under audit.

***Proposed Amendments to the Investment Company Complex***

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?*

   **Response:**

   We support the proposal to specifically reference the entity under audit within the ICC definition. Including the ICC within the affiliate definition has resulted in some diversity in practice with respect to how to apply each prong to various audit client types. Separating the two definitions by type of audit client will provide clarity. However, we suggest that the SEC define the term "entity under audit" rather than introduce another undefined term. The current language in the audit client definition in Rule 2-01(f)(6), "… the entity whose financial statements or other information is being audited, reviewed, or attested, …" could be used for consistency. We also note that the Commission has introduced this term in proposed Rule 2-01(f)(4)(ii).

   We also support including unregistered funds in the definition of investment company for purposes of paragraph (f)(14) in the proposed amendments. Using the operating company affiliate definition in Rule 2-01(f)(4) for unregistered funds has frequently led to the identification of affiliates where an auditor's services and relationships would be unlikely to impair objectivity or impartiality. Aligning the unregistered funds and registered funds using the ICC to define affiliates recognizes the significant commonalities across different fund types and substantially rationalizes the application of the independence rules for asset management companies that manage both registered and unregistered funds. Viewing the asset management industry holistically will serve the interests of investors and provide for more consistent treatment across fund businesses.

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?*

   **Response:**

   We believe that it is appropriate to use the ICC definition to identify affiliates of an investment adviser, sponsor or investment company (both registered and unregistered funds). The ICC definition better captures the relevant entities for purposes of evaluating independence by focusing on those entities that directly relate to the entity under audit. By establishing a common rule across the asset management industry, there would be more consistency in independence analyses by audit clients and auditors.

   However, we note that the proposal does not provide an explanation for including an investment adviser or sponsor as an entity under audit in the ICC definition. We assume that the Commission meant to align the affiliate definition for all attest engagements required by the SEC's Custody Rule (i.e., audit of a pooled investment company, surprise custody examination, or internal control report). If this is the purpose, we support this approach; however, we believe that a further clarification is necessary. In many cases, the Custody Rule internal control report engagement is performed at a custodian that is a related entity to the investment adviser, rather than at the investment adviser itself. By adding only investment advisers to the ICC, affiliates of a related custodian where a Custody Rule internal control report is issued would continue to be determined using the operating company affiliate definition in Rule 2-01(f)(4)(i). We recommend that the ICC definition include such custodians and specify that the definition is intended to include investment advisers and custodians for which attest engagements under the Custody Rule are performed.

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)?*

**Response:**

We support the proposed amendment to include a materiality qualifier in Rule 2-01(f)(14)(i)(D), which would better focus the definition of affiliates on entities most relevant to the entity under audit. We believe that the focus should be on whether these sister investment companies, advisers, or sponsors are material to the controlling entity. In almost all situations, a sister entity and the entity under audit would not have an investment in each other, so assessing materiality of the sister entity to the entity under audit would not be pragmatic. For the same reasons outlined in our response to Question 1, we recommend that the definition in Rule 2-01(f)(14)(i)(D) be amended to include sister investment advisers and investment companies only when both the sister entity and the investment adviser under audit, or the investment adviser/sponsor of an investment company under audit, are material to the controlling entity. In situations when the facts or circumstances indicate that services or relationships between the auditor and a non-affiliate sister entity to the entity under audit impair the auditor's objectivity and impartiality, the general standard in Rule 2-01(b) would be sufficient to disallow providing the service or establishing the relationship.

We do not believe the amendments to the definition should require the aggregation of sister entities in the materiality assessment. In practice, if the definition required aggregating sister entities, and just one entity in the group is material, then that would unnecessarily capture all of the other immaterial entities as affiliates. We believe that the evaluation should be performed on an individual-entity basis to correctly exclude entities where an auditor's services or relationships are unlikely to pose a threat to the auditor's objectivity and impartiality. As noted previously, we believe that, when the facts or circumstances indicate that services or relationships between the auditor and a non-affiliate sister entity to the entity under audit impair the auditor's objectivity and impartiality, the general standard in Rule 2-01(b) would be sufficient to disallow providing the service or establishing the relationship.

9. *Does the proposed amendment sufficiently focus the common control prong of the ICC definition on those relationships and services 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?*

**Response:**

We agree that the introduction of a materiality test to the common control prong correctly focuses attention on those relationships and services that are most likely to threaten auditor objectivity and impartiality.

However, with respect to many unregistered funds, we believe that the control prong of the ICC definition, Rule 2-01(f)(14)(C), may inadvertently be capturing certain entities under common control of the entity under audit without regard to materiality. For example, when auditing a fund, the control prong of the ICC would capture all entities controlled by that fund's investment adviser or sponsor. For a private equity investment adviser, that could be construed to include all controlled portfolio companies in any fund managed by that investment adviser, even though those portfolio companies are under common control with the fund audit client. We believe that services and relationships with such portfolio companies, particularly when they are immaterial to the investment adviser, generally do not pose threats to a fund auditor's objectivity and impartiality and thus should not be captured as affiliates in the ICC, just as portfolio companies held by funds managed by a sister adviser would not be captured in the ICC. This could be accomplished by providing an exception within the control prong to exclude entities controlled by an adviser or sponsor identified in (f)(14)(i)(B) through an investment company managed by such adviser or sponsor other than the entity under audit.

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?*

**Response:**

We believe that auditors and audit clients will generally be able to manage challenges in applying the materiality concept outlined in the proposed amendments. Our experience in applying the materiality concept is that the availability and accessibility of information necessary to perform the calculations can, in some situations, be a challenge. For example, where an auditor audits a fund but not any other entities in a complex, the auditor may not have access to a sister entity's financial information. In some cases, clients may also not currently produce financial information at the level of the immediate controlling entity, thereby requiring clients to develop additional financial reporting to accommodate these materiality assessments. However, auditors generally have engagement agreements with audit clients that require their assistance in making these evaluations and should be able to develop and implement sufficient procedures to support the necessary evaluations.

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?*

**Response:**

We do not believe focusing only on those sister entities that are material to the controlling entity will unduly increase the risk that auditors will be performing audits when they are not objective and impartial. In fact, by clearly delineating between material and immaterial entities, we believe that the auditor and the audit client will rightly focus attention on services and relationships that could reasonably have an impact upon the impartiality and objectivity of the auditor. When the facts or circumstances indicate that services or relationships between the auditor and a non-affiliate sister entity to the entity under audit impair the auditor's objectivity and impartiality (in fact or appearance), the general standard in Rule 2-01(b) would be sufficient to disallow providing the service or establishing the relationship.

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?*

**Response:**

While this scenario is not likely to be common, we support the proposal to assess whether sister investment companies are material to the controlling entity even in instances where their adviser is not material. We note that, consistent with our comments in Section F of this letter, participation of management is essential when making materiality assessments for purposes of determining affiliates of the audit client. We encourage the Commission to reflect management's responsibilities with respect to the assessment of materiality in the release accompanying the final rule.

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)?*

**Response:**

Yes, we believe that investment companies that share an investment adviser or sponsor included within the ICC definition should also be included in the ICC definition, as proposed in paragraph (f)(14)(i)(F). We concur that the nature of the relationship between an investment adviser or sponsor and the investment companies that it advises is such that, once an investment adviser or sponsor is included within the proposed ICC definition, the investment companies that it advises should be included as well.

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

**Response:**

Yes. We believe that the significant influence prong in the ICC definition as proposed is needed to capture material significant influence portfolio company investees of the entity under audit (e.g., a fund) as affiliates, consistent with the operating company affiliate definition and the AICPA affiliate definition.

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)?*

**Response:**

Yes. We agree that the reference to paragraph (f)(14)(i)(E) should be added to paragraph (f)(6) in order to capture all affiliates subject to the exception provided by this rule.

***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?*

**Response:**

We agree with the Commission's proposal to apply the same one-year look-back provision that is currently available to a foreign private issuer (FPI) to a domestic US company when a company first files, or is required to file, a registration statement or report with the Commission, such as an initial public offering (IPO). This change would address an inconsistency in the current auditor independence rules that provide for a shorter period for evaluation of independence under the SEC rules for FPIs in a first-filing situation than the period it provides to domestic registrants.

We do not believe the alternative approach of harmonizing the rule for both domestic and FPI issuers by instead lengthening the look-back period for compliance with the SEC independence rules is warranted. Currently, Rule 2-01(f)(5) requires an FPI to fully comply with home-country independence standards for all periods presented in the initial registration statements (typically two or three years of audited financial statements) to be able to use the one-year look-back provision. This same requirement — to fully comply with applicable independence standards, which, for a domestic US company, is the AICPA standards — is in the proposed amendment. A company aspiring to register with the SEC (whether foreign or domestic) will plan for the event with its auditor; however, such planning will typically not be done as far as three years out from the IPO. Unnecessary incremental cost to a company can arise when such advanced planning is necessary to be in a position to comply with rules that do not yet apply. Lengthening the look-back period for FPIs may also delay or derail a company's plans to go public if a re-audit of historical financial statements by an SEC independent auditor is needed. The one-year look-back provision for compliance with the SEC independence rules, together with the requirement for full compliance with home-country independence standards for all periods, has functioned in the marketplace as intended for FPIs; it has protected investors and, in turn, has facilitated capital formation. We believe that this same one-year look-back provision should be available to domestic US companies.

If Rule 2-01(f)(5) is adopted as amended, we recommend that the Commission provide guidance in the release accompanying the final rule permitting the use of the look-back provision in Rule 2-01(f)(5) for a company (either a domestic company or a company that will qualify as an FPI) that merges with a public shell company. Currently, staff guidance in Section 12250.1 of the *Division of Corporation Finance Financial Reporting Manual* provides for the use of the look-back provision in Rule 2-01(f)(5) for a private operating company that qualifies as an FPI when merging with a public shell company.[1] This would expand the consistency of application of current rules for FPIs to domestic companies similar to the proposed amendment and improve clarity by codifying guidance into the release accompanying the final rule.

## B. Proposed Amendments to Loans or Debtor-Creditor Relationships

***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?*

**Response:**

We support the Commission's proposal to include an exception for student loans from an audit client obtained under normal lending procedures, terms and requirements for a covered person's educational expenses provided that the loan was obtained by the professional prior to becoming a covered person in the firm. Historically, the independence rules have provided certain exceptions recognizing that not all creditor or debtor relationships threaten an auditor's objectivity and impartiality. We believe that student loans would also not threaten an auditor's objectivity or impartiality if obtained prior to the professional becoming a covered person under normal lending procedures, terms and requirements. Permitting a student loan that was negotiated and obtained prior to the professional becoming a covered person is a concept that is applied in Rule 2-01(c)(1)(ii)(A)(1)(iv) with respect to mortgage loans and in other aspects of the Commission's

[1] Section 12250.1, *Reverse Recapitalization with a Public Shell Company*, in the Division of Corporation Finance Financial Reporting Manual states, "For Form 20-F, the auditor of an accounting acquirer that is a foreign private issuer must comply with SEC/PCAOB independence rules at least for the latest fiscal year as long as the auditor is independent in accordance with home-country standards for earlier periods. [S-X 2-01(f)(5)(iii)]."

rules,[2] and it recognizes that a professional's objectivity and impartiality are not compromised in those circumstances.

We encourage the Commission to permit immediate family members' student loans obtained under normal lending procedures, terms and requirements prior to the professional becoming a covered person. Permitting these loans is consistent with the other exceptions currently allowed under Rule 2-01(c)(1)(ii)(A) (e.g., mortgage loans collateralized by the borrower's primary residence, automobile loans), which permit loans to immediate family members, and we believe that an immediate family member's student loan with an audit client likewise would not threaten an auditor's objectivity and impartiality when obtained under the aforementioned conditions. Further, when evaluating the potential threats to objectivity and impartiality, it is difficult to understand the rationale for prohibiting the student loans of a covered person's immediate family members while permitting such loans for the covered person.

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?*

**Response:**

As stated in our response to Question 17, we believe that all student loans obtained under normal lending procedures, terms and requirements prior to the professional becoming a covered person should be permitted. If the Commission expands the exception to include immediate family members in the proposed amendment, we believe that the overarching considerations required by Rule 2-01(b) are sufficient to mitigate against any potential risk that student loans obtained for multiple immediate family members could be so significant that they impact the auditor's objectivity and impartiality. Therefore, it is unnecessary to include a limit on the amounts of such loans outstanding.

We do not believe that the proposed exception should apply to only the covered person's "accounting and auditing educational expenses." To do so could lead to situations that are inconsistent with the objectives of the proposed amendment. For example, there could be an inconsistency in applying the proposed rule to similar types of covered persons, such as audit engagement team members, where the student loans of one engagement team member are permitted, while the student loans of another are not for reasons with no apparent relevance to the independence assessment. Consider an engagement team member who is a valuation or actuarial specialist who did not incur "accounting or auditing educational expenses" and whose

[2] Similarly, Rule 2-01(c)(1)(ii)(F) allows a covered person to retain an insurance policy if the policy was obtained prior to the professional becoming a covered person and the likelihood of the insurer becoming insolvent is remote.

student loans would be impermissible, while other audit engagement team members would be allowed to have such student loans. Additionally, if such a provision were to be adopted, "accounting and auditing educational expenses" would need to be well defined to ensure consistent application of the proposed rule.

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

**Response:**

No. We believe that Rule 2-01(c) should place no limit on the amount outstanding, since the overarching considerations required in Rule 2-01(b) are sufficient to mitigate against any potential risk that would impact the auditor's objectivity and impartiality. The important conditions for permitting such loans and that support auditor objectivity and impartiality are included in the proposed amendment. Specifically, the student loan would be permissible if it was obtained under normal lending procedures, terms and requirements and was obtained prior to the professional becoming a covered person.

***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?*

**Response:**

Yes, we agree with the Commission's proposal to revise Rule 2-01(c)(1)(ii)(A)(1)(iv) to refer to "mortgage loans" instead of "mortgage loan." This revision is consistent with Section B, Financial Relationships, Question 1 of the Office of the Chief Accountant's Frequently Asked Questions (FAQ), June 27, 2019; originally issued August 13, 2003. Further, we recommend that the staff guidance in the response to the FAQ permitting a mortgage loan in circumstances when the borrower becomes a covered person because of a change in the ownership of the loan (and provided that there is no modification in the original terms or conditions of the loan or obligation after the borrower becomes, or in contemplation of the borrower becoming, a covered person) be included in the release accompanying the final rule.

***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?*

**Response:**

We support the Commission's proposal to amend Rule 2-01(c)(1)(ii)(E) to replace "credit cards" with "consumer loans." This proposed amendment modernizes the rule to account for the types of consumer financing that borrowers routinely obtain for personal consumption. We believe that consumer loans obtained by a covered person with an audit client would not impact the auditor's objectivity and impartiality, taking into account the balance outstanding at the payment due date, including any grace period.

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

**Response:**

We suggest that the outstanding balance limit of $10,000 be raised to $20,000 to take into account inflation since the adoption of the rule in 2001.

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

**Response:**

We do not believe further guidance is needed on this topic.

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?*

**Response:**

We do not believe further guidance is needed on this topic.

**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?*

**Response:**

Yes, "substantial stockholders" in the business relationships rule should be replaced with the concept of beneficial owners with significant influence. As with the amended loan provision, the concept of significant influence focuses the independence analysis more effectively on those relationships that may threaten auditor independence (in fact or appearance). In addition, the concept of significant influence is well established in accounting literature;[3] is recognized by preparers, users and auditors of financial statements; and is used in the amended loan provision and in other areas of the independence rules promulgated by the

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[3] Financial Accounting Standards Board Accounting Standards Codification 323, *Investments – Equity Method and Joint Ventures*.

Commission and the AICPA standards. Conversely, the term "substantial stockholder" is not defined in Regulation S-X and, as a result, there is diversity in applying the rule. Replacing the reference to "substantial stockholder" with the concept of beneficial owners with significant influence would significantly improve the rule by focusing the analysis on those relationships that may impair an auditor's objectivity and impartiality while improving consistency of application due to the use of a well-established term understood by preparers and auditors alike.

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?*

**Response:**

We believe that the proposed change would likely result in fewer instances of business relationships that are prohibited under Rule 2-01(c)(3). The proposed amendment importantly would also more appropriately identify relationships that are likely to impair an auditor's objectivity and impartiality than the current rule by focusing the independence analysis on those relationships that may bear on an auditor's objectivity and impartiality (in fact or appearance). As a result, the amendment may increase the number of qualified audit firms from which an issuer can choose.

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?*

**Response:**

It is increasingly common for companies to enter into multi-company arrangements in delivering products or services where an audit firm may contribute to such arrangements that can include an audit client. In many situations, these arrangements can be properly structured to safeguard the audit firm's objectivity and impartiality with respect to the audit client. While we do not believe that further amendments are required to identify where it would be more likely that an auditor's objectivity and impartiality would be impaired, we do believe that it would be beneficial for the Commission to work with the profession to provide additional guidance with regard to the application of the current rules to these arrangements.

The following examples highlight some of the arrangements that may occur:

- Arrangements where a non-audit client prime contractor may select the audit firm as a subcontractor, and the prime contractor has separately (without input from the audit firm) selected an audit client (potentially along with other third-party subcontractors) as another subcontractor under the same proposal or engagement.

- Arrangements in which an audit client is a data provider or a technology service provider to a non-audit client and the audit firm also provides professional services to the non-audit client to integrate data feeds/technology linkages to the audit client; the auditor and the audit client do not assist each other in the delivery of each party's respective products or services, do not recommend or refer the other to the non-audit client and have no financial dependency with respect to fees to be earned under the engagement.

- Arrangements where the audit firm provides services to assist a non-audit client in developing and/or operating a blockchain technology platform that the non-audit client will use to provide services to its customers or to create a blockchain network involving third-party participants (the blockchain participants) that may include audit clients. Common characteristics of these relationships often include one or more of the following:

    i. The non-audit client's technology platform may include the audit firm's intellectual property that is licensed to the non-audit client, in addition to third-party software elements also licensed by the non-audit client.
    ii. The non-audit client's solution may include software provided by the audit client.
    iii. The non-audit client directs and takes responsibility for the blockchain technology platform, the selection of any third-party software and the use of the blockchain platform for its business purposes.
    iv. Once the blockchain technology platform is built and accepted by the client, the audit firm has no ongoing relationship with the non-audit client with respect to delivering or supporting the blockchain network for the blockchain participants, other than potentially providing break-fix support services with respect to the technology elements licensed by the audit firm to the non-audit client. The audit firm also has no liability or obligations to the blockchain participants.

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?*

**Response:**

Yes, the guidance in the proposal is appropriate. This guidance clarifies that the focus of the business relationship rule is on those business relationships with persons in a decision-making capacity as it relates to the entity under audit. It is also appropriate that this guidance applies the same concepts in the amended loan provision. Placing the focus on beneficial owners who have significant influence over the entity under audit, and not on beneficial owners who do not have such influence over the entity under audit, provides appropriate safeguards against relationships that may pose a threat to an auditor's objectivity and impartiality.

To conform the SEC's rules with the guidance referred to in this question and in Section II.C.2 of the proposal, we recommend that the Commission modify the final rule related to business relationships (Rule 2-01(c)(3)) and the amended loan provision (Rule 2-01(c)(1)(ii)(A)) by adding reference to officers or directors with significant influence and replacing one reference to "audit client" with "entity under audit". Specifically, both the amended loan provision and the proposed business relationship rule include the phrase "… an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such <u>beneficial owner</u> has significant influence over the <u>audit client</u> …" (emphasis added). The term "audit client," which is a defined term and includes the entity under audit and affiliates, is reflected several times within this phrase. The first two references to audit client appropriately focus the independence analysis on officers, directors or beneficial owners of the audit client (including affiliates) where such persons have significant influence with respect to the entity under audit. This is consistent with the guidance in Section II.C.2 of the proposal. However, the end of this phrase only references a beneficial owner, not an officer or director, which is inconsistent with the Commission's guidance. In addition, by using the term "audit client" as opposed to "entity under audit", the intended objective of the Commission's guidance is negated since the rule would prohibit a lending or business relationship with a person that has significant influence at an affiliate of the entity under audit but not at the entity under audit. This would lead to rule violations that have no impact on an auditor's objectivity or impartiality and by using a defined term improperly, creates a clear conflict between the Commission's guidance and the Commission's amended loan provision and business relationship rule. To correct these issues, we recommend the Commission replace the phrase "… where such beneficial owner has significant influence over the <u>audit client</u>" in the proposed rule related to business relationships and the amended loan provision with "… where such <u>officer, director or</u> beneficial owner has significant influence over the <u>entity under audit</u>" (emphasis added).

As discussed in our response to Question 5, we also recommend that the Commission define the term "entity under audit" in Rule 2-01(f) to enhance clarity and consistent application. We further note that the Commission's proposed amendments introduce the term "entity under audit" in Rule 2-01(f)(4)(ii) and Rule 2-01(f)(14)(i)(A), thereby making it more important that the Commission use that term consistently where it is meant to be applied.

Finally, we understand that there are different views by auditors and companies as to how to evaluate a business relationship with an entity controlled by a substantial stockholder of the audit client under the Commission's business relationships rule. Some consider such a business relationship to always be a "direct" business relationship because the business relationship is with an entity controlled by a substantial stockholder and therefore prohibited, while others under certain facts and circumstances, consider the relationship to be an "indirect" business relationship, which is prohibited only if it is material. We recommend the Commission clarify how a business relationship with an entity controlled by a substantial stockholder should be evaluated under the business relationships rule (or under the proposed amendment, a business relationship with an entity controlled by a beneficial owner with significant influence over the entity under audit). In considering this clarification, we recommend that the Commission consider that it permits, under the recently amended loan provision, lending relationships between the audit firm and entities that are controlled by the beneficial owner of the audit client's equity securities even when such beneficial owner has significant influence over the audit client.[4]

**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?*

    **Response:**

    We believe that the transition framework should address inadvertent independence matters arising from mergers and acquisitions as proposed. The proposed transition framework incorporates important safeguards that protect investors while providing a practical approach for addressing issues that, through no action or oversight on the part of the audit firm, and with negligible impacts on auditor objectivity and impartiality, can often have an adverse effect on a registrant and its investors.

    We do not believe that the proposed transition framework should be expanded to encompass IPOs. As the Commission has observed in the proposal, the root cause of auditor independence issues arising from mergers and acquisitions often differ from those arising from IPOs. In particular, when a company executes an IPO, the auditor often has an existing auditor-client relationship with the audit client, and the IPO is typically contemplated well in advance of its consummation, which offers more opportunity for the auditor and client to transition services that would be inconsistent with SEC independence rules.

    We also do not believe that other transactions should be covered by the proposed transition framework. As described in our response to Question 34, we believe that the transition framework should encompass all merger and acquisition transactions, including a transaction involving a public shell company or a reverse merger with a registrant that is an operating company. This would also include an acquisition of a noncontrolling interest in an entity that would make the entity an affiliate of the audit client.

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

    **Response:**

    The proposed transition framework requires the auditor to have in place a quality control system for monitoring the audit client's merger and acquisition activity to provide timely notice of a merger or

[4] See Section II.B.3 (page 20) of the final rule on *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships.*

acquisition and prompt identification of potential violations after notification of a potential merger or acquisition. The controls that we have in place for compliance with the existing quality control requirements in Rule 2-01(d) provide reasonable assurance of timely notice of merger and acquisition activity and prompt identification of potential violations. Nevertheless, to promote consistency in interpretation and application of the rule by registrants, accounting firms, regulators and other stakeholders, we recommend that the Commission provide guidance in the release accompanying the final rule clarifying how those applying the transition provision, if adopted as proposed, should interpret the phrases "timely notice" and "prompt identification."

To further promote consistency in interpretation and application of the rule, we recommend that the Commission clarify in the release accompanying the final rule whether the transition framework can be applied when the audit firm does not identify a merger or acquisition until after the close of the transaction, provided that the conditions in Rule 2-01(e), as proposed, are met.[5] We believe that the proposed transition framework can, and should, be used in such situations. A quality control system that includes procedures and controls referenced in the proposed amendments and described in Rule 2-01(d) may, at times, not identify merger or acquisition transactions prior to the close of the transaction. Transactions where this is more likely to occur include acquisitions that are not initiated by the entity under audit, such as merger or acquisition transactions consummated by the parent or a sister affiliate. Confidentiality considerations related to a transaction also can impact the timing of communications to the audit firm. In these instances, the conditions provided in proposed Rule 2-01(e) would still need to be met to allow the audit firm to use the transition framework, and the audit firm must evaluate the independence matter under the general standard in Rule 2-01(b).

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

**Response:**

We believe that the listed criteria in the proposed rule provide appropriate guidance. However, we believe that this portion of the proposed rule may benefit from discussion in the release accompanying the final rule of the Commission's expectations of procedures and controls that registrants (not just accounting firms) should have in place to inform auditors of pending mergers and acquisitions.

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?*

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[5] It is not clear whether the phrase "but before the transaction has occurred" in Rule 2-01(e)(iii)(B), as proposed, would preclude the use of the transition framework when the audit firm does not identify a merger or transaction until after the close of the transaction.

**Response:**

We believe that the transition provision should apply to all services and relationships that would potentially result in an SEC independence violation. The proposed transition framework already requires the auditor to comply with the applicable independence standards related to services or relationships when originated, meet additional specified conditions, and have in place a quality control framework for monitoring the audit client's merger and acquisition activity. In addition, Rule 2-01(b) must be considered in all such situations. We believe the proposed transition framework, together with Rule 2-01(b), provides sufficient investor protection to effectively address matters arising from merger and acquisition transactions, and that no further modifications in this regard are necessary.

We also believe that a matter arising from a merger and acquisition transaction would not constitute a violation of the SEC independence rules when the conditions in Rule 2-01(e), as proposed, are met. However, it is not clear from the proposed amendments or the discussion of the proposed amendments whether or not the Commission's position is that prohibited services or relationships that meet the conditions under the proposed transition framework would constitute a violation of the SEC independence rules. For the avoidance of doubt, this should be clarified in the rule amendments or the release accompanying the final rule. Although these matters would be reported to audit committees for their consideration, we believe that reporting such a matter as a rule violation that does not result in the impairment of the audit firm's independence could lead to confusion on the part of audit committees in performing their governance function.

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?*

**Response:**

Consistent with the proposal, we believe that six months is a reasonable period after the consummation of most merger or acquisition transactions to allow an auditor to address matters covered by the proposed transition framework. While we believe that, in the majority of situations, such matters can be resolved in less than six months after the effective date of the merger or acquisition, a six-month maximum period is already applied by companies and auditors under a similar transition framework in audit engagements subject to the IESBA code.[6] Therefore, using a six-month maximum period for resolution of matters subject to the proposed transition framework would promote harmonization with the IESBA code.

[6] See Section R400.73 of the IESBA code.

To further promote consistency in interpretation and application of the rule, we believe that the final rule should specify the maximum period (e.g., six months) for all corrective actions to have been taken after the effective date of the merger or acquisition that triggered the matter.

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?*

**Response:**

No. We do not believe that certain types of merger and acquisition transactions should be excluded from the proposed transition framework. Any exclusions will increase complexity and could substantially lessen the extent to which the proposed transition framework supports the intended objective to provide a reasonable transition period for inadvertent independence matters that arise from merger or acquisition transactions and that do not compromise auditor objectivity and impartiality. While a transaction such as a reverse merger by a nonpublic company with a public shell company has similarities to an IPO, such a transaction or a reverse merger with a registrant operating company generally occurs with less advance notice compared to a typical IPO and presents the same challenge as other merger and acquisition transactions: they can lead to inadvertent independence violations that may delay or prevent the closing of a transaction to the possible detriment of the audit client and its investors. Accordingly, because the root cause of auditor independence issues in reverse merger transactions with a public shell company is similar to other types of merger and acquisition transactions, we do not believe that it is appropriate to exclude these or other types of merger and acquisition transactions from the proposed transition framework that, in tandem with the general standard in Rule 2-01(b), preserves investor protection.

**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?*

**Response:**

Yes. We agree with the miscellaneous updates described in Section II.E of the proposal. There are no other conforming amendments that the Commission should make in light of the updates listed in Section II.E of the proposal.

F. Additional Considerations

***PCAOB Independence Standards***

In April 2003, the Public Company Accounting Oversight Board (PCAOB) issued Rule 3500T, *Interim Ethics and Independence Standards*, which adopted as the PCAOB's interim ethics and independence standards certain preexisting ethics standards described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder. PCAOB Rule 3500T states that, to the extent that a provision of the Commission's auditor independence rules is more restrictive – or less restrictive – than the PCAOB's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule. Further, PCAOB Rule 3501, *Definition of Terms Employed in Section 3, Part 5 of the Rules*, includes "affiliate of the audit client," "audit and professional engagement period" and "investment company complex" definitions that currently are consistent with the Commission's definitions in Rule 2-01(f), but would not be consistent if the Commission's proposed amendments are adopted in whole or part.

Because elements of the Commission's proposed amendments if adopted would conflict with the PCAOB's ethics and independence standards, and, in some cases, would provide for less restrictive rules than PCAOB standards (e.g., the proposed amendment to Rule 2-01(c)(1)(ii)(E) related to consumer loans), we recommend that the Commission work with the PCAOB to address inconsistencies between the Commission's independence rules and the PCAOB's independence standards.

***Shared Responsibility – Affiliate Identification and Determination***

Consistent with the Commission's long-held view that independence is a shared responsibility between the auditor and the audit client, we believe that the SEC should include language in its release accompanying the final rule regarding management's responsibilities in identifying and determining affiliates of the audit client.

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We would be pleased to discuss our comments with the Commission or its staff at its convenience.

Yours sincerely,

Ernst + Young LLP