March 16, 2020

By email: rule-comments@sec.gov

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

Re: File Number S7-26-19: Amendments to Rule 2-01, Qualifications of Accountants; Release Nos. 33-10738; 34-87864; IC-33737; IA-5422.

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs (AICPA). This letter represents the observations of the CAQ but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ believes auditor independence is foundational to audit quality. Being independent is a core part of the auditor's role, and thus maintaining and enhancing independence are top priorities for the auditing profession. As such, we appreciate the opportunity to share our views and provide input on the Securities and Exchange Commission's (Commission or SEC) Proposed Rule, *Amendments to Rule 2-01, Qualification of Accountants* (Proposed Rule or proposal). The CAQ firmly believes that the Commission's auditor independence requirements play a critical role in helping to protect the reliability and integrity of financial statements issued by registrants. We are committed to helping ensure that modifications to the Commission's auditor independence requirements are designed to continue enhancing investor protection.

The CAQ supports the Commission's goal of modernizing certain aspects of the auditor independence framework set forth in Rule 2-01 of Regulation

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S-X.[1] We acknowledge the Commission's thoughtful package of proposals, and commend the effort of the Commission and the Staff in analyzing not only the comments received on the Commission's recent amendments to its loan provision,[2] but also the Commission's decades of experience in administering the independence requirements. We also concur with the Commission's view that it is imperative "to maintain the relevance of [the] auditor independence requirements, and evaluate their effectiveness in light of current market conditions and industry practices."[3] For example, the private equity sector has experienced notable growth in the past twenty years. The growth in the number of private equity firms and portfolio companies controlled by such firms coupled with the frequency and volume of transaction activity can lead to situations under the current independence requirements where services or relationships with sister entities (as defined below) in the private equity complex have to be terminated because the sister entity suddenly becomes an affiliate of an audit client as a result of a transaction. In light of the scale of the portfolios of companies controlled by private equity firms and the rapid pace of transaction activity, the level of disruption experienced by portfolio companies in private equity structures caused by having to terminate these services and relationships on short notice can be significant. And, where the service or relationship at issue arises at an immaterial sister entity, there often is no commensurate benefit for investor protection. As a result, we share the view that the amendments in the Proposed Rule will help to more effectively focus independence analyses on those relationships or services that have an increased likelihood of posing threats to an auditor's objectivity and impartiality.[4]

As highlighted in the proposing release, we recognize the significance of the SEC's general standard of auditor independence in Rule 2-01(b) that an accountant will not be recognized as independent "if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement," and that it is appropriate to consider "all relevant circumstances" in assessing independence.[5] Indeed, we recognize that independence in fact and in appearance is central to an accounting firm's ability to discharge properly its role as an auditor. We believe that the amendments and clarifications set forth in the proposal are faithful to these key objectives.

In this letter, we provide detail regarding our support for the specific elements of the Proposed Rule and offer a few additional considerations, including in response to certain questions posed by the Commission in its proposal.

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1 *See SEC Proposes to Codify Certain Consultations and Modernize Auditor Independence Rules*, Press Release 2019-276 (Dec. 30, 2019).

2 *See Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release No. 33-10491 (May 2, 2018) ("Loan Provision Amendments").

3 Proposed Rule, page 6.

4 Proposed Rule, page 6.

5 17 C.F.R. § 210.2-01(b).

I. Proposed Amendments to the Independence Requirements

A. Proposal to Modify the Common Control Prong of the Affiliate of the Audit Client Definition

Under the current rule, entities under common control with the audit client ("sister entities") are considered "affiliates of the audit client" and fall within the definition of the "audit client."[6] The proposal amends the common control prong in Rule 2-01(f)(4) of Regulation S-X to include a materiality qualifier such that the sister entity would only be deemed an affiliate of the audit client if the sister entity is material to the entity that has control over both the sister entity and the entity under audit. We support this proposal.

The common control prong can present numerous practical challenges for registrants and audit firms because the current definition in our view expands beyond those entities that are reasonably likely to pose independence concerns with respect to an audited entity. The costs and burdens in applying the current affiliate definition are not insignificant, and some of these costs ultimately are borne by shareholders. Substantial resources are devoted to monitoring these affiliate relationships, even though in many circumstances, as described in the proposing release, no reasonable investor would perceive any adverse impact on the auditor's objectivity or impartiality as a result of the relationships.[7]

In particular, many of the challenges that registrants and audit firms confront as a result of this definition occur in the private equity space. For example, independence issues currently can arise where an audit firm provides non-audit services to an immaterial sister entity that is not an entity under audit, and that sister entity is under common control (through a private equity firm relationship) with the entity under audit – even though neither the sister entity nor the entity under audit controls or exerts any influence over the other. As observed in the proposing release, "audit firms providing services to or having relationships with sister entities not material to the controlling entity do not typically present issues with respect to the audit firm's objectivity or impartiality."[8] We share this view.

The challenges associated with the current affiliate rule as outlined above are notable even if the structure of the private equity firm and its portfolio companies was static. Yet, these challenges are exacerbated by the fast-moving pace and heavy volume of transactions that predominate in private equity structures. For example, when a company is acquired by a private equity firm in a market-place transaction, non-audit services performed for that company by an accounting firm (or business relationships with that firm) may have to be terminated on short notice because, by virtue of the acquisition, the company has become a sister entity to all portfolio companies under common control of the private equity firm. In light of the massive scale of the portfolios of companies controlled by private equity firms and the frequency of transaction activity, the level of disruption for audit clients and their affiliates caused by having to terminate these services and relationships on short notice is significant and costly to the entity without a commensurate benefit to investor protection, particularly where the service or relationship at issue arises at an immaterial sister entity. These challenges also arise where a private equity firm seeks to take a controlled

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[6] 17 C.F.R. § 210.2-01(f)(4)(i) and (f)(6).

[7] Proposed Rule, page 9.

[8] Proposed Rule, page 12.

portfolio company public in the United States. In this situation, relationships and services provided to all controlled sister entities in the private equity firm's portfolio – relationships and services which would have been permissible at inception under otherwise applicable independence standards – would have to be re-examined under SEC requirements to assess whether there are any issues with respect to the common control provision. We believe these situations demonstrate that the current common control prong of the affiliate definition should be revised as proposed.

From our perspective, the amendment is a targeted modification and should prove beneficial in focusing the definition of affiliate of the audit client on relationships that are most likely to threaten the auditor's objectivity and impartiality. Including a materiality qualifier should better serve investors by reducing compliance costs while maintaining protections that are designed to promote auditor objectivity and impartiality. Consistent with the Commission's observations,[9] we also believe the proposal would have a positive impact on competition by expanding choices that registrants have in seeking providers for audit and non-audit services for the reasons noted in the proposal. For these reasons, we support the proposal to amend the common control prong to add a materiality qualifier for sister entities.

The proposal also notes that the amendment as it relates to sister entities "is consistent, in part, with the definition of 'affiliate' used by the [AICPA] in its ethics and independence rules."[10] Although we support the amendment as proposed, we believe the Commission should consider modifying the control prongs so that they fully align with the AICPA definition – that is, by requiring that (1) a sister entity be deemed an affiliate where both the sister entity and the entity under audit are material to the controlling entity, and (2) the entity that controls the entity under audit be deemed an affiliate when the entity under audit is material to the controlling entity. This approach not only would align with the AICPA approach, but also would align with the approach used by the International Ethics Standards Board for Accountants (IESBA), which also has adopted independence standards that are frequently used by foreign audit firms.[11] Both the AICPA and IESBA standards are well-established and accepted frameworks, and alignment in this complex area would help promote compliance and monitoring of affiliate relationships on a consistent basis internationally. Specifically, it would be helpful to have a common protocol that could be applied across systems that are used to track and evaluate complex organizational structures. This approach would prove beneficial because it would help reduce complexity and would harmonize the common control prong of the SEC affiliate definition with existing IESBA and AICPA

[9] Proposed Rule, page 9 (noting that where an entity is seeking a new auditor "the number of qualified audit firms may be reduced because certain audit firms may have relationships with or provide services to sister entities that are impermissible under the current auditor independence rules regardless of the impact to the objectivity or impartiality of the audit firm").

[10] Proposed Rule, page 13.

[11] *See* AICPA Code of Professional Conduct, 0.400.02 (defining "affiliate" to include "[a] sister entity of a financial statement attest client if the financial statement attest client and sister are each material to the entity that controls both"; and "[a]n entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity"); IESBA, Handbook of the Code of Ethics for Professional Accountants, "Definitions" (defining "related entity" – which is IESBA's terminology for affiliate of the audit client – to include "[a]n entity which is under common control with the client (a 'sister entity') if the sister entity and the client are both material to the entity that controls both the client and sister entity"; and "[a]n entity that has direct or indirect control over the client if the client is material to such entity.").

standards. In addition, when the entity under audit is immaterial to the controlling entity, we believe it is less likely the auditor's relationships with other entities under common control would impact the auditor's ability to maintain objectivity and impartiality through the audit engagement. We recognize of course that even with these additional suggestions, the amendments would not alter the application of the general standard in Rule 2-01(b).

Finally, the proposal observes that the concept of materiality already is embedded and applied within the significant influence prongs of the affiliate of the audit client definition and thus the evaluation is one with which auditors should be familiar.[12] We agree with these statements in the proposing release and believe audit firms are experienced in exercising judgments in relation to the materiality principles that already exist in the SEC's independence requirements. As such, we do not believe further guidance on this topic is necessary at this time, although the SEC Staff may determine in the future it is appropriate to issue guidance regarding this topic as it observes practices in this area through its consultation process. In addition, given that the information needed to identify affiliates, including information needed to make relevant materiality determinations, is often only available through the audit client, the Commission should reiterate that audit firms and registrants have a shared responsibility to monitor affiliates.

B. Proposal to Modify the Investment Company Complex Definition

We commend the Commission for its proposal to modify the structure of the affiliate of the audit client definition to make it explicit that in situations where the entity under audit is an investment company or an investment adviser or sponsor, the auditor should look solely to the investment company complex ("ICC") definition in Rule 2-01(f)(14) of Regulation S-X. This change will bring valuable clarity to the complement of definitions at play in the affiliate context – i.e., the affiliate definition in Rule 2-01(f)(4) and the ICC definition (which also includes affiliate concepts) in Rule 2-01(f)(14). With this new structure, the appropriate elements of these definitions can be applied consistently to operating company structures, on the one hand, and ICC organizational structures, on the other.

Notwithstanding our support for this aspect of the proposal, we encourage the Commission to clarify how the two sets of rules should operate if the investment adviser is the entity under audit and also happens to be an issuer and the parent entity. Similarly, it would be helpful if the Commission clarified that in a scenario where the entity under audit is an operating company and it has a commonly-controlled sister entity that is an investment company, investment adviser or sponsor (but which is not itself an entity under audit), the relationship with the sister entity would be evaluated solely under the affiliate definition in Rule 2-01(f)(4) and not under the ICC definition.

The proposal also aligns the common control prong of the ICC definition such that only sister investment companies (with different advisers), sister advisers, and sister sponsors that are material to the controlling entity would be deemed affiliates of the ICC entity under audit. We support this proposal for reasons discussed in the preceding section. We believe that this tailored revision will help to reduce some of the compliance burden related to monitoring immaterial entities in the ICC structure (which typically should not present a real threat to independence) while still preserving meaningful protection for investors with respect to relationships involving other ICC affiliates. We also concur with the Commission's observation that "[t]he inclusion of a

[12] Proposed Rule, page 12-13.

materiality qualifier in [the common control prong of the ICC definition] may broaden the pool of prospective accountants the potential investment company audit client can evaluate and consider to engage as its auditor while being unlikely to increase the potential threat to an auditor's objectivity and impartiality."[13] As a point of clarification, we note that proposed Rule 2-01(f)(14)(i)(C) includes "[a]ny entity controlled by or controlling any investment adviser or sponsor" of the fund entity under audit. In a private equity context, this provision could be viewed to include controlled portfolio companies in other funds advised by that adviser or sponsor. We urge the Commission to clarify that those controlled portfolio companies in other funds would not be captured by this prong of the ICC definition, or at a minimum, provide for a materiality test consistent with that applied to other commonly-controlled sister entities.

We also support the proposal to align the ICC definition with the affiliate of the audit client definition by importing the significant influence prongs into the ICC definition. Given the restructuring of the related definitions, it is appropriate to import the significant influence prongs from Rule 2-01(f)(4) into the ICC definition in Rule 2-01(f)(14) to help ensure that the latter definition captures relationships with entities that a reasonable investor might view as having an impact on an auditor's independence.

Finally, given the inherent complexities in applying the affiliate definition in Rule 2-01(f)(4) and the ICC definition in Rule 2-01(f)(14), we encourage the Commission and its Staff to consider including additional illustrations on the application of these amended definitions, either in the release adopting the final rule or through other Staff guidance such as FAQs.

C. Application of Independence Rules in Context of IPOs and M&A Transactions

1. Initial Public Offerings ("IPOs") – Currently, the definition of "audit and professional engagement period" includes a section providing that the auditor of a foreign private issuer seeking to go public has to be independent under the SEC's rules only during the immediately preceding fiscal year, provided there has been full compliance with home country independence standards for all prior periods covered by the registration statement.[14] The proposal modifies this section of the "audit and professional engagement period" definition so that all first-time filers – foreign and domestic – are subject to the same provision. We support this proposal.

Under the current auditor independence rules, the auditor of a domestic private company that is seeking to go public has to be independent in accordance with the SEC's independence rules for all financial statement periods included in the issuer's registration statement filed with the SEC – typically two to three years of audited financial statements. Thus, for domestic companies seeking to transition from private to public by pursuing an IPO, there currently is no transition period from the set of independence rules that governs private company audits to the Commission's full independence rule set that governs public company audits.

We are concerned that the absence of a transition period may be hindering or delaying capital formation because of the significant challenges that can arise in evaluating whether an audit firm

[13] Proposed Rule, page 19.

[14] 17 C.F.R. § 210.02-01(f)(5)(iii) (providing that the "audit and professional engagement period" for a foreign private issuer does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed a registration statement or report with the Commission).

has been independent under SEC and PCAOB rules during the entire two- or three-year period before an IPO, rather than permitting would-be public companies to use audit firms that are independent in those periods under AICPA or other applicable independence standards. Private companies that aspire to go public and the audit firms of course will engage in advance planning for an IPO, but the historical periods for which SEC/PCAOB independence is currently required sometimes may precede when the IPO planning practically would have commenced. Considerable additional expense can arise in these situations due to the need to evaluate the permissibility under SEC and PCAOB rules of relationships and non-audit services provided in all years presented in a registration statement. The result of this evaluation could require the company to switch to a new auditor, which can delay or derail the domestic company's decision to go public. As noted earlier, these challenges can be particularly acute for portfolio companies of private equity firms given the expansive and changing affiliate relationships that have to be retrospectively analyzed.

Applying the same independence framework that foreign private issuers are subject to in connection with IPOs presents a reasonable approach to addressing this issue. We believe this transition relief will continue to provide robust investor protection and address the challenges noted. It would continue to promote investor protection because the audits of the earliest financial statement years included in the registration statement still would have to comply with well-accepted independence standards – i.e., AICPA, IESBA, or other local standards. And, the audit of the most recent historical year of financial statements still would have to comply with SEC/PCAOB standards (as well as applicable local standards). As observed in the proposing release, the "[Commission] believe[s] that the proposed requirement [that the issuer has] to comply with [other] applicable independence requirements in all prior periods sufficiently mitigates the risk associated with shortening the look back provision."[15] We share this view and believe the proposal appropriately balances the interests of helping to ensure investor protection while also taking steps to spur capital formation.

Finally, in the release accompanying the final rule, we believe it would be helpful to clarify that the guidance in the Division of Corporation Finance's Financial Reporting Manual ("FRM") regarding the applicability of Rule 2-01(f)(5)(iii) to a reverse recapitalization by a non-public company with a public shell company (where the accounting acquirer is a foreign private issuer) also should apply to domestic issuers.[16]

2. *Merger and Acquisition Transactions* – The proposal includes a framework for addressing inadvertent auditor independence issues that arise in the context of merger and acquisition transactions. Specifically, the proposed framework requires that the auditor must be in compliance with the applicable independence standards related to the services or relationships when the services or relationships originated, and have in place a quality control system for monitoring the audit client's merger and acquisition activity. Under the proposed framework, the auditor would be required to correct the independence issue arising from the merger or acquisition as promptly as possible under the relevant circumstances associated with the merger or acquisition. We support this aspect of the proposal.

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[15] Proposed Rule, page 27.

[16] *See* FRM at 12250.1.b.

The current rules do not provide for any transition period when a transaction occurs during an audit or professional engagement period, and the closing of the transaction triggers a violation. For example, this could occur when the audited entity acquires a company to which the audit firm (or a member of its global network) provides non-audit services that, although permitted prior to the transaction, become prohibited with respect to the acquiring, audited entity as a result of the transaction. As the proposing release observes, these situations arise through "no action of the audit firm."[17] When these situations arise, audit firms move expeditiously to correct the issue by transitioning out of the relationship or service, typically by the time the transaction closes. In some instances, however, the independence issue may need to be corrected after the closing of the transaction. This can occur due to complications in winding down the relationship or service without causing significant disruption to the acquired entity. This situation also can arise because the service or relationship is identified at the time of the closing or soon thereafter.

The proposal appropriately recognizes the challenges these situations present and reiterates that when these situations are identified, the audit firm still must address a post-transaction transition as promptly as possible under the relevant circumstances. The proposing release underscores that for independence issues identified in connection with merger and acquisition activity, the expectation is that "all corrective action would be taken no later than six months after the effective date of the merger or acquisition that triggered the independence violation."[18] As reflected in the proposing release, the framework aligns with the international standards in the IESBA Code of Ethics that are used to assess independence issues that arise in connection with mergers and acquisition transactions, and thus the framework is anchored in a standard with which registrants and audit firms already have familiarity applying.[19] We support the SEC's proposed framework and the related guidance and believe it sets forth a practical step for addressing issues that arise due to a merger or acquisition transaction in a prompt, orderly manner. We also urge the Commission to clarify that the framework applies to situations where the service or relationship is identified at or after the transaction closing date but still addressed within the transition framework window.

Finally, in a situation where the criteria in the transition framework have been satisfied, we would expect that the matter would not be viewed as a violation of the SEC's independence requirements. This would be consistent with the approach under the IESBA Code of Ethics, where an issue that arises in the context of a merger or acquisition transaction satisfies the framework it is not treated as a violation of the code. We encourage the Commission to confirm this perspective in the release adopting the final rule or in the final rule itself.

D. Proposal to Amend the Reference to "Substantial Stockholder" in The Business Relationship Rule

The business relationship rule prohibits direct or material indirect business relationships between the accountant and the audit client or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or *substantial stockholders*.[20] The

[17] Proposed Rule, page 38.

[18] Proposed Rule, pages 41-42.

[19] Proposed Rule, page 42.

[20] 17 C.F.R. § 210.02-01(c)(3).

proposal removes the phrase "substantial stockholders" and replaces it with the significant influence investor test used in the SEC's recently amended loan provision – that is, "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client."[21] We support this aspect of the proposal.

The "substantial stockholder" in a decision-making capacity concept is not defined in the SEC's rules or guidance and as such, the phrase is susceptible to varying interpretations. Conversely, the significant influence test is a well-established concept that already exists in the Commission's auditor independence requirements;[22] as a result, it is a standard that audit firms and registrants are familiar with and can readily apply. As reflected in the proposal, the significant influence test is rooted in the accounting principle found in FASB Accounting Standards Codification (ASC) 323, *Investments – Equity Method and Joint Ventures*.[23] As such, the ASC lends itself to application both by accounting firms and registrants. Because the proposal conforms with the investor concept adopted in the Loan Provision Amendments, the approach also should promote compliance from a systems and operational perspective as firms should be able to derive benefits from applying a common test across different elements of the independence requirements.

In addition, focusing on significant influence of the beneficial owner better serves to identify possible relationships where a shareholder might be able to have a decision-making role with the audited entity such that a business relationship with that shareholder might be viewed to impact the objectivity or impartiality of the audit firm. In our view, the proposal better aligns with the underlying purpose sought to be achieved in helping to ensure independence. For the reasons described above, we believe the Commission's proposal to replace the substantial stockholder phrase with the significant influence test represents an appropriate modification to the business relationship rule.

In making this change, we encourage the Commission to specify in the release adopting the final rule, as it did in the release accompanying the Loan Provision Amendments, that "entities that are under common control with or controlled by the beneficial owner of the audit client's equity securities when such beneficial owner has significant influence over the audit client, are excluded from the scope" of the rule.[24]

Separately, the proposing release includes guidance to clarify that the focus of this rule is on those business relationships with persons in a decision-making capacity that are associated with the entity under audit. As a result, the proposing release reflects that the independence analysis should focus on whether "the beneficial owner has significant influence over the entity under audit, since business relationships with persons with such influence could be reasonably be expected to impact an auditor's objectivity and impartiality."[25] Conversely, where a beneficial owner of equity securities of an affiliate of the audit client potentially has significant influence over the affiliate but not over the entity under audit, there typically should not be a threat to the auditor's

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[21] Loan Provision Amendments; 17 C.F.R. § 210.02-01(c)(1)(ii)(A).

[22] *See, e.g.,* 17 C.F.R. § 210.2-01(f)(4)(ii) and (iii).

[23] Proposed Rule, page 35.

[24] *See* Loan Provision Amendments, at page 20.

[25] Proposed Rule, page 36.

objectivity and impartiality. We believe this is helpful guidance, and encourage the Commission to include this in the final rule or in the release accompanying the final rule. If the Commission were to modify the final rule to address this point, the last clause in the first sentence of Rule 2-01(c)(3) could be changed to read "…where such beneficial owner has significant influence over the entity under audit." We also believe the clarification provided in the proposing release that this guidance applies to the same concepts present in the recent Loan Provision Amendment reflects beneficial guidance that will help promote compliance with those requirements.[26]

Finally, in the context of business relationships, the proposing release asks if clarifications should be provided with respect to multi-company arrangements in delivering products or services to which an audit firm may contribute.[27] In this regard, we note that it is increasingly common for organizations to form multiparty "ecosystems" or consortia, combining a multitude of capabilities possessed by different companies in order to compete in a rapidly innovating, technology-driven economy. These arrangements may take a variety of different forms. For example, an audit firm may be requested to enter into an arrangement with several companies to deliver services to one or more third parties, or the audit firm may be requested to provide services or contribute intellectual property to a consortium created to enable the participants to contribute and have access to data using a common technology platform.

Auditor independence requirements currently preclude an accountant from having any direct or material indirect business relationship with an audit client, unless the accountant is acting as a "consumer in the ordinary course of business." When an audit firm and its client are both parties to an arrangement such as those described in the preceding paragraph, all relevant facts and circumstances should be taken into consideration in order to determine whether the auditor would be able to maintain its independence in fact and appearance.

The audit firm has an obligation to see that its impartiality and objectivity are safeguarded, and the facts and circumstances of each arrangement must be assessed against this overriding principle as required by the general standard of auditor independence in Rule 2-01(b). For example, factors that could be used in evaluating an arrangement in this area might include whether the arrangement: (a) involves a diversified consortium, such as three or more participants, (b) is established based on arm's length terms and conditions, (c) is non-exclusive, such that the audit firm and its client participants are free to pursue similar arrangements with other market participants, (d) is immaterial to the audit firm, and (e) has been communicated to those charged with governance as appropriate. Of course, any services or products offered for sale by the consortium to an audit client also would have to comply with all applicable scope of services restrictions. We believe the discussion above presents relevant considerations for the Staff in the event it moves forward with a process to develop guidance in this area.

[26] Proposed Rule, pages 36-37.

[27] Proposed Rule, page 38.

E. Proposal to Amend Independence Rules with Respect to Debtor-Creditor Relationships

As noted in the proposal, certain loan relationships and debtor-creditor relationships between the accountant and the audit client raise independence concerns.[28] However, in recognition that not all debtor or creditor relationships will threaten an auditor's objectivity or impartiality, the independence rules have historically included certain limited exceptions to the general prohibition on loans.[29] The proposal includes three limited revisions to the debtor-creditor provisions to address certain recurring issues the SEC Staff has identified and that have been raised in prior comments.[30] We support these revisions to the debtor-creditor rules.

Specifically, the proposal would add an exception for student loans obtained from an audit client under its normal lending procedures, terms, and requirements for a covered person's educational expenses, provided the loan was obtained by the individual prior to becoming a covered person in the audit firm. We do not believe that a student loan obtained by an individual before becoming a covered person with respect to an audit client presents an actual threat to the auditor's objectivity or impartiality. The addition thus should be viewed as a reasonable addition to the list of permissible debtor-creditor relationships in Rule 2-01(c)(1). The proposing release goes on to comment that that the proposal was not extended to include student loans obtained by immediate family members of the covered person due to a concern that the amount of the student loan borrowings for all immediate family members potentially could affect the covered person's objectivity. We encourage the Commission to consider extending the proposal to cover student loans obtained by spouses and dependents. If such loans are obtained by the immediate family member while the individual is not a covered person, we would not expect that a financial obligation to an audited entity that was obtained on normal lending terms would present a threat to the covered person's objectivity.

Also, although we would expect that the ordinary meaning of "educational expenses" would include expenses for room and board, books, and other educational supplies, as well as tuition expenses, it may be helpful for the Commission to clarify the scope of this phrase in its release accompanying the final rule. The proposal also inquires whether the exception should be limited to "accounting and auditing" educational expenses. The rationale for the exception is that because the student loan would have been obtained while the individual was not a covered person, there is no threat to the individual's objectivity and impartiality. The applicability of this rationale is not dependent on the nature of the courses that the student loan paid for, and thus we do not believe the exception should be limited only to "accounting and auditing" educational expenses.

Separately, the proposal seeks to clarify that the mortgage loan exception can apply to multiple mortgage loans on a primary residence, not a single loan. In addition, the proposal revises the exception for personal credit card debt on a current basis, so that the exception would apply to consumer financing transactions generally (such as cell phone plans, retail installment loans), as well as credit cards. Because both revisions are narrow in scope and are designed to address recurring issues in a practical fashion, we are supportive of these proposals. Finally, we

[28] Proposed Rule, page 28.

[29] 17 C.F.R. § 210.02-01(c)(1)(ii).

[30] Proposed Rule, page 29.

encourage the Commission to consider allowing for periodic indexing of the dollar threshold in the rule so as to account for inflation.

II. Additional Considerations

A. Application of PCAOB Independence Provisions

As the Commission is aware, the PCAOB has adopted certain interim ethics and independence standards.[31] A note to the relevant PCAOB rule provides that "to the extent that a provision of the [SEC's] rule 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."[32] We note that the PCAOB's interim independence standards include a general prohibition on loans with covered persons and a list of exceptions, much like the construct in the existing SEC debtor-creditor provisions.[33] If the debtor-creditor provisions set forth in the proposal are adopted, the list of exceptions in the PCAOB interim independence standards could be viewed as "more restrictive" than the list of exceptions in the SEC's amended debtor-creditor provisions. Moreover, we note that PCAOB Rules 3501(a)(ii) ("Affiliate of the Audit Client"), 3501(a)(iii) ("Audit and Professional Engagement Period"), and 3501(i)(ii) ("Investment Company Complex") would need to be amended to conform to the SEC's proposed amendments to these terms. As a result, the Commission may wish to engage in a dialogue with the PCAOB as to whether there is a benefit to updating the PCAOB's interim independence standards and definitions noted above in light of certain of the amended rules in the proposal.

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[31] *See* PCAOB Rule 3500T. Interim Ethics and Independence Standards.

[32] PCAOB Rule 3500T, Note.

[33] *See* PCAOB Interim Independence Standards, ET Section 101.07 (Other Permitted Loans).

We believe the modifications in the proposal are helpful for maintaining the relevance of the rules by seeking to align the overall approach to independence with current market conditions and industry structures. The modifications also should help facilitate capital formation, while maintaining independence in fact and appearance and thereby continuing to promote investor confidence in the audit process.

We appreciate the opportunity to comment on the questions raised in the proposal. As the Commission and Staff gather feedback from other interested parties, we would be pleased to discuss our comments or answer any questions that the Commissioners or Staff may have regarding the views expressed in this letter.

Sincerely,

Catherine Ide
Senior Managing Director of Professional Practice and Member Services
Center for Audit Quality

cc:

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