March 16, 2019

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Amendments to Rule 2-01, Qualifications of Accountants

Dear Ms. Countryman:

The American Investment Council (the "AIC"), on behalf of its members, is pleased to provide comments to the Securities and Exchange Commission (the "Commission" or the "SEC") in response to its recent rule proposing release, Amendments to Rule 2-01, Qualifications of Accountants (the "Proposing Release").[1]

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes and distributes information about the private equity and growth capital industry and its contributions to the U.S. and global economy. Established in 2007, and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

The AIC and its members appreciate the substantial efforts undertaken by the Commission and its staff (the "Staff") over the past several years to modernize the framework governing auditor independence under Rule 2-01 of Regulation S-X ("Rule 2-01"). We share the Commission's view, expressed in the adopting release accompanying the 2000 amendments to Rule 2-01[2] and reiterated in the Proposing Release,[3] that independent auditors provide critical assurance to the investing public; that standards for independence must remain relevant, effective and fair; and that the effectiveness of such standards should be evaluated in light of current market conditions and industry practices.

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1 *Amendments to Rule 2-01, Qualifications of Accountants,* Release Nos. 33-10738, 34-87864, FR-86; IA-5422, IC-33737; File No. S7-26-19 (available at https://www.sec.gov/rules/proposed/2019/33-10738.pdf).

2 See *Revision of the Commission's Auditor Independence Requirements*, Release Nos. 33-7919, 34-43602, 35-27279, IC-24744, IA-1911, FR-56; File No. S7-13-00 (available at https://www.sec.gov/rules/final/33-7919.htm), at text accompanying footnotes 8-11.

3 See Proposing Release, at 6.

It is in light of these objectives, the AIC applauds the Commission's recognition of the need to revisit the comprehensive framework for auditor independence that it adopted in 2000. As the Proposing Release notes,[4] with the exception of revisions made in connection with the amendments required by the Sarbanes-Oxley Act in 2002 and the amendments to the "loan rule provision" adopted in 2019,[5] the vast majority of the provisions in Rule 2-01 have remain unchanged since their adoption. During the intervening two decades, the landscape of the securities markets, and the financial services industry more broadly, has changed substantially, including with respect to private equity firms.[6]

- Following the implementation of the Dodd-Frank Act's amendments to the registration provisions of the Investment Advisers Act of 1940 (the "Advisers Act") and the adoption of the Commission's implementing regulations, in 2012 over 1,500 private fund investment advisers were required to become registered with the Commission for the first time -- a number that by 2019, according to the SEC's Form PF statistics,[7] had grown to over 3,100, including over 1,250 investment advisers that reported managing nearly 13,000 private equity funds, representing over $3 trillion of gross assets.
- The role of private equity and growth capital firms as providers of capital has also grown substantially, with such firms, in 2019 alone, investing over $699 billion of capital through more than 4,000 transactions.[8]

Like firms in virtually every industry, private equity firms compete globally for investment opportunities and capital, as do the portfolio companies in which they invest. As a result, the regulatory regimes under which private equity firms and portfolio companies operate have a profound impact on capital formation.

As discussed in the AIC's comment letters of July 9, 2018 (the "2018 AIC Letter") and July 26, 2019 (the "2019 AIC Letter"), the auditor independence standards set forth in Rule 2-01 apply to private equity firms most significantly with respect to (i) audited financial statements that are filed with the Commission (most frequently in connection with the initial public offering (IPO) of a portfolio company); and (ii) audited financial statements of private equity funds that are provided to investors in the funds in order to comply with the Advisers Act "custody rule,"[9] which requires the auditor to qualify as an "independent public accountant" as provided in Rule 2-01.

The current approach to auditor independence under Rule 2-01 imposes substantial and, in certain respects, disproportionate transaction costs on private equity firms, the funds they advise, existing or prospective portfolio companies of the funds, and ultimately, the funds' investors. These costs can distort the economic decisions that are made by both the private equity firm and portfolio company investors in connection with transactions. In many instances, such transaction costs and economic distortions can be traced to (i) the

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4 See Proposing Release, at 6.

5 *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release Nos. 33-10648, 34-86127, FR-85, IA-5255, IC-33511; File No. S7-10-18 (available at https://www.sec.gov/rules/final/2019/ 33-10648.pdf) (the "Loan Provision Adopting Release").

6 As used in this letter, the term "private equity firm" includes private equity funds and upper-tier entities (including management entities and general partners of funds), but excludes portfolio companies of private equity funds.

7 See *Private Fund Statistics, Second Calendar Quarter 2019*, January 29, 2020 (available at https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2019-q2.pdf).

8 See Pitchbook source data for 2019.

9 Advisers Act Rule 206(4)-2, *Custody of funds or securities of clients by investment advisers* (available at https://www.law.cornell.edu/cfr/text/17/275.206(4)-2).

over-inclusive treatment of affiliates in the definitions of "audit client" and "affiliate of the audit client" in Rule 2-01, (ii) the absence of any transition period for merger and acquisition (M&A) transactions, and (iii) for IPO transactions, the requirement that the auditor for a domestic issuer be independent under the Commission's independence rules effectively for the three years prior to the filing of a registration statement with the Commission.

The AIC therefore supports the efforts of the Commission to address these matters. Nevertheless, the AIC remains concerned that certain of the amendments contemplated in the Proposing Release, particularly regarding the treatment of affiliates, if adopted as proposed, would fall short of addressing in a meaningful way the substantial ongoing monitoring and compliance burdens and restrictions on business activities faced by private equity firms and their portfolio companies in the application of Rule 2-01. We therefore encourage the Commission to consider further incremental changes that would more broadly address affiliation in the context of portfolio companies owned by entities within private equity firms. We believe that, with these additional changes, the Commission's proposal could substantially alleviate the burdens faced by private equity firms, while continuing to ensure both the objectivity and impartiality of accounting firms who serve as independent auditors, and the confidence of the investing public.

As discussed more fully below, the AIC:

1. Supports the Commission's proposed amendments to Rule 2-01(e) in order to provide for a transition period with respect to certain merger and acquisition transactions, but recommends that the Commission consider clarifying that the proposed transition framework can also be applied to pre-existing services and relationships that are identified shortly after closing and resolved as promptly as possible but no later than six months after closing;

2. Supports the Commission's proposed amendments to Rule 2-01(f)(5) in order to conform the definition of "audit and professional engagement period" for both domestic issuers and foreign private issuers;

3. Supports the Commission's efforts to address the treatment of common control entities under Rule 2-01(f)(4) and Rule 2-01(f)(14), but further recommends (a) amending the provisions to provide that an entity which is under common control with the entity under audit will be considered an affiliate of the entity under audit only if both such entities are material to the controlling entity, and (b) amending proposed Rule 2-01(f)(14)(i)(C) to clarify that when the entity under audit is an investment company within an investment company complex, an operating company controlled by the investment adviser to such investment company would not be considered an "affiliate of the audit client";

4. Recommends that the Commission further amend proposed Rule 2-01(f)(4)(i) and Rule 2-01(f)(14)(i)(C) to provide that an entity which is a direct or indirect controlling entity of the entity under audit will be considered an affiliate of the entity under audit only if the entity under audit is material to the direct or indirect controlling entity;

5. Supports the Commission's proposed amendments to Rule 2-01(c)(3) to replace the reference to "substantial stockholders" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client", but recommends that the Commission consider clarifications conforming to Rule 2-01(c)(1)(ii)(A) (the "Loan Provision") so that entities under common control with, or controlled by, a beneficial owner with significant influence, are excluded from the scope of the business relationship rule; and

6. Requests that the Commission (a) provide additional guidance on the determination of materiality by private equity firms in the context of Rule 2-01, (b) consider defining "controlling entity" for purposes determining affiliation under Rule 2-01 to mean the ultimate controlling entity of a private equity firm, (c) clarify the obligations of accounting firms and their clients in assessing the application of the standard in Rule 2-01(b) to certain entities that would no longer be considered "affiliates of the audit client" under the amended rule and (d) support any efforts by the PCAOB to conform its independence rules in light of the amendments to Rule 2-01 that are ultimately adopted by the Commission..

Subject to the modifications summarized above and discussed below, the AIC believes that the amendments contemplated in the Proposing Release would substantially enhance auditor choice and competition, in a manner that is consistent with the Commission's mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.

1. ***The AIC supports the proposed amendments to Rule 2-01(e) in order to provide for a transition period with respect to certain merger and acquisition transactions, but recommends that the Commission consider clarifying that the proposed transition framework can also be applied to pre-existing services and relationships that are identified shortly after closing and resolved as promptly as possible but no later than six months after closing.***

The amendments contemplated in the Proposing Release include the implementation of a transition framework for mergers and acquisitions to address inadvertent violations related to such transactions so the auditor and its audit client can transition out of prohibited services and relationships in an orderly manner. The AIC supports this change.

As described in the 2018 AIC Letter, AIC member firms have encountered frequent challenges in the application of Rule 2-01 in the merger and acquisition context, most commonly stemming from a private equity fund acquiring control of a portfolio company, which results in the portfolio company being considered under common control with the other entities in the private equity firm as well as with the portfolio companies held by the private equity firm's fund clients. In such cases, a private equity firm must often decide between (i) the immediate and previously unforeseen termination of independence-impairing non-audit service arrangements and/or relationships, often resulting in significant disruptions to the businesses of the relevant portfolio company, or (ii) changing auditors, which is disruptive and costly to the relevant portfolio company, and can also be exceptionally challenging because other accounting firms often have pre-existing, independence-impairing non-audit service arrangements and/or relationships with existing portfolio companies and entities within the private equity firm. The AIC believes that a transition framework as contemplated in the Proposing Release would help alleviate such issues, and the associated time-consuming evaluations and discussions with audit committees and/or the Staff, which often must take place on a compressed timeframe. We further believe that the transition framework would not, from the standpoint of a reasonable investor, impair the objectivity and impartiality of the accounting firm from which the private equity firm and/or its other portfolio companies receive audit services.

The AIC agrees with the Commission that in most instances, potential independence issues resulting from merger and acquisition transactions could be identified and resolved before a transaction's closing, and where orderly transition cannot occur prior to closing, prohibited relationships and services should be corrected as promptly as possible but no more than six months after the transaction's effective date. However, as further detailed below, a multitude of acquisition or disposition transactions involving portfolio companies may be under consideration, actively pursued, or completed by the funds within the private equity complex, while at the same time, additional funds are being raised or liquidated. The high frequency and speed of these transactions result in ever-changing landscapes of portfolio companies, which

poses significant challenges for private equity complexes to manage, track and communicate such changes to their auditors in a timely manner. The AIC recommends the Commission consider clarifying that the proposed transition framework could be applied to pre-existing services and relationships that are identified shortly after a transaction's closing, and are resolved as promptly as possible but no more than six months after closing.

2. ***The AIC supports the proposed amendments to Rule 2-01(f)(5) in order to conform the definition of "audit and professional engagement period" for both domestic issuers and foreign private issuers.***

The Proposing Release amendments would also revise the definition of "audit and professional engagement period" in Rule 2-01(f)(5) to provide for a one-year look-back provision that applies to both domestic issuers and foreign private issuers ("FPIs") filing an initial registration statement or report with the Commission. Under the current requirements of Rule 2-01, a private equity firm seeking to take public a controlled portfolio company of one of its advised funds in the United States must evaluate relationships and services provided to all controlled companies in all of the funds it advises, sometimes looking back three years, to evaluate whether there are any independence issues with respect to the common control provisions. An FPI, however, is able to take advantage of a provision that requires the FPI's auditor to be independent under the Commission's independence rules for only the most recent audited fiscal year and all subsequent periods.

Because this same provision is not available to domestic issuers, current Rule 2-01(f)(4) has placed US-based companies at a disadvantage relative to FPIs. This has often resulted in domestic companies incurring significant costs, having to obtain re-audits of historical periods and/or delaying in accessing the public markets, as compared to FPIs. It also advantages non-U.S. markets over U.S. markets with respect to securities listings. The AIC does not believe that there is compelling evidence to suggest that investor protection justifies differential treatment of domestic issuers and FPIs, and therefore agrees with the proposal to conform the definition of "audit and professional engagement period" for both types of registrants.

3. ***The AIC supports the Commission's efforts to address the treatment of common control entities under Rule 2-01(f)(4) and Rule 2-01(f)(14), but further recommends (a) amending the provisions to provide that an entity which is under common control with the entity under audit will be considered an affiliate of the entity under audit only if both such entities are material to the controlling entity, and (b) amending proposed Rule 2-01(f)(14)(i)(C) to clarify that when the entity under audit is an investment company within an investment company complex, an operating company controlled by the investment adviser to such investment company would not be considered an "affiliate of the audit client".***

Under the amendments contemplated in the Proposing Release, the definition of "affiliate of the audit client" in Rule 2-01(f)(4)(i)(B) would include, among others, any entity that "is under common control with the audit client, … unless the entity is not material to the controlling entity." Similarly, proposed changes to the definition of "investment company complex" would provide, pursuant to proposed Rule 2-01(f)(14)(i)(D), that when the entity under audit is an investment company or investment adviser, investment companies and investment advisers under common control with such entity under audit would be considered affiliates of that entity unless they are not material to the controlling entity.

The AIC concurs with the Staff's observation, cited in the Proposing Release, that "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."[10] However, based on the AIC's experience, we believe it is equally true that where either the entity under audit or the sister entity is not material to the controlling entity, services to or relationships with the sister entity do not impair an audit firm's objectivity and impartiality. We believe it is for similar reasons that both the AICPA Code of Professional Conduct (the "AICPA Code")[11] and the IESBA International Code of Ethics for Professional Accountants (the "IESBA Code")[12] only treat commonly controlled entities as affiliates where both such entities are material to the controlling parent. More specifically, Section 1.200.400.02 of the AICPA Code defines an "affiliate" of a "financial statement attest client" to include "[a] sister entity of a financial statement attest client if the financial statement attest client and sister entity are each material to the entity that controls both" (emphasis added). Similarly, the IESBA Code provides that a "related entity" of an audit client includes "[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" (emphasis added).

The Proposing Release suggests that the Commission's decision to focus on the materiality of the sister entity to the controlling parent, rather than on both the sister entity and the entity under audit, reflects concern that the AICPA approach may be under-inclusive of relationships and services which could impair an auditor's objectivity and impartiality.[13] We would expect, however, that any relationship between a portfolio company and an accountant that is so substantial as to potentially impair the accountant's objectivity and impartiality would run afoul of the standard set forth in Rule 2-01(b), under which the Commission will not recognize an accountant as independent with respect to an audit client if "the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." Furthermore, we believe that procedures implemented by accounting firms, private equity firms and portfolio companies can readily identify any such relationships or services that are independence-impairing under the Rule 2-01(b) standard.

By contrast, the AIC believes that, as currently contemplated, the Commission's proposed change to Rule 2-01(f)(4)(i)(B) would only have, at best, a marginal benefit for private equity firms. In fact, the more likely and unfortunate result is that the change would increase the burden on private equity firms, for the reasons explained below.

As the Commission is aware, accounting firms maintain extensive controls and procedures for identifying potential independence impairments under Rule 2-01. The accounting firms' controls and procedures are supported by information provided and maintained by private equity firms, who are responsible for identifying entities within the private equity firm structure, including affiliated portfolio companies (and the portfolio companies' affiliates). But under the proposed change, the determination of whether one portfolio company is an "affiliate" of a sister portfolio company that is under audit would require even more time, expense and other resources than are expended for such determinations today. This is due not only to the size and complexity of many private equity firms, but also to the continuously evolving universe of

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[10] Proposing Release, at 12.

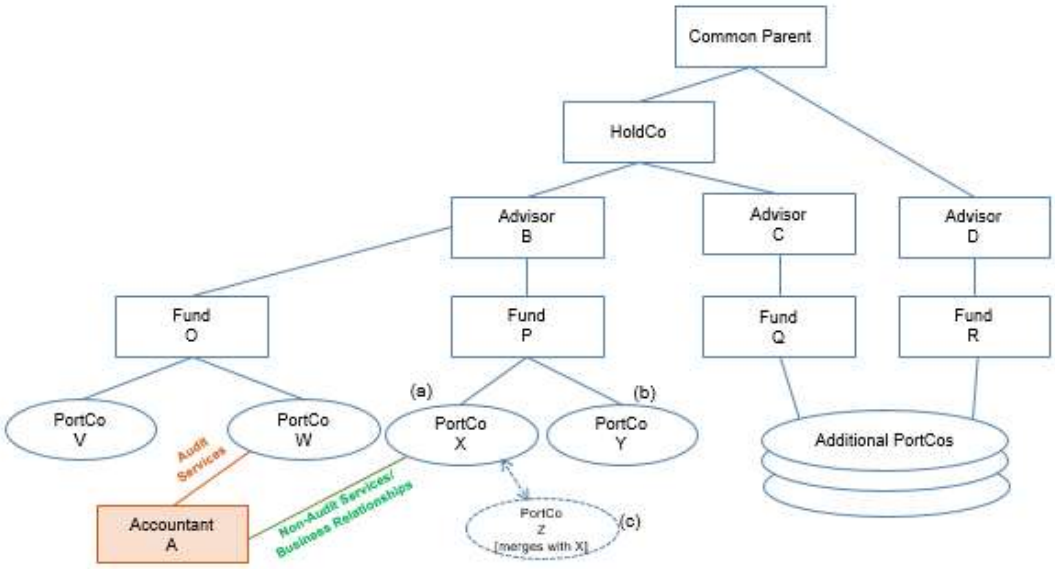
[11] AICPA Code of Professional Conduct (effective December 15, 2014; available at https://pub.aicpa.org/codeofconduct/Ethics.aspx).

[12] International Code of Ethics for Professional Accountants (including International Independence Standards) (effective June 15, 2019; available at https://www.ethicsboard.org/international-code-ethics-professional-accountants).

[13] Proposing Release, at footnote 20.

entities that the private equity firm would need to address, as well as the ever-changing nature of the materiality determination to common parents.

The challenges are perhaps best demonstrated with an example. For purposes of this discussion, we assume the structure set forth below (which is greatly simplified compared to the actual structure of even a relatively small private equity firm).



For illustrative purposes, assume that PortCo W is an issuer whose securities are registered with the Commission, that the amendments contemplated by the Proposing Release are adopted as proposed and that, in the subsequent year, the following events take place.

(a) In Q1 20x1, Advisor B launches Fund P. Fund P obtains its first capital commitments from third-party investors in an initial closing in the same quarter. Fund P draws on these capital commitments to make its first investment, in PortCo X. Based on the size of the investment and other relevant factors, PortCo X is considered "material" to Adviser B. PortCo X thus is an "affiliate" of PortCo W, even if PortCo W is not material to Adviser B.

(b) In Q4 20x1, Fund P has its second closing and raises substantially more capital commitments. It draws on these capital commitments to make a second investment, in PortCo Y. As a result, the value of PortCo X, as a percentage of Fund P's assets, declines significantly. Consequently, PortCo X is no longer considered "material" to Adviser B. PortCo X thus is no longer an "affiliate" of PortCo W.

(c) In Q1 20x2, Fund P draws on the capital commitments from its investors in order to fund the acquisition of PortCo Z, which merges into PortCo X. As a result, the value of PortCo X, as a percentage of Fund P's assets, increases. Consequently, PortCo X is again considered "material" to Adviser B. PortCo X thus is again an "affiliate" of PortCo W.

Under these examples, if PortCo X received prohibited non-audit services from, or had prohibited business relationships with, Accountant A, the status of Accountant A's independence under proposed Rule 2-01, based solely on the three foregoing actions, would have changed <u>four</u> times:

- In Q1 20x1, PortCo X is an "affiliate" of PortCo W. However, Accountant A's independence is deemed not to have been impaired under the transition rule provided by amended Rule 2-01(e).

- In Q3 20x1, PortCo X continues to be an affiliate of PortCo W, but the transition period has expired. As a result, Accountant A's independence with respect to PortCo W would be deemed to be impaired unless Accountant A has terminated its non-audit services or business relationships with PortCo X.

- In Q4 20x1, PortCo X is no longer an affiliate of PortCo W. As a result, Accountant A could again be considered independent from PortCo W.

- In Q1 20x2, PortCo X is again an affiliate of PortCo W. As a result, Accountant A's independence with respect to PortCo W is deemed to be impaired.

In other words, the status of Accountant A's independence vis-a-vis PortCo W changes four times over the course of a single year, despite the fact that (i) PortCo W has always been, and remains, immaterial to Advisor B, and (ii) PortCo W has neither sought nor experienced any change in the nature of the audit services that it receives from Accountant A. In fact, PortCo W would likely have no reason to even be aware of PortCo X or the services it receives, except due to the need of its private equity parent entities to comply with Rule 2-01.

While the foregoing is a simplified and stylized example, it is not unrealistic. In fact, a real-life private equity firm will often have many more funds and other investment vehicles simultaneously under management — perhaps dozens, if not hundreds — as well as additional investment advisers and intermediate holding companies under the same ultimate parent. At any given moment in time, a multitude of acquisition or disposition transactions involving portfolio companies may be under consideration, actively pursued, or completed by the funds within the private equity firm, while at the same time additional funds are being raised or liquidated. Any number of these transactions may involve existing or prospective portfolio companies that rely upon accounting firms to serve as independent auditors, on the one hand, or for the provision of business-critical non-audit services or other benefits from business relationships, on the other hand. In the example above, the actions described with respect to PortCo X could equally as well have been taken with respect to PortCo Y or other portfolio companies in Fund O, Fund Q and Fund R, such that the materiality analysis would have to consider entirely different common parent entities (namely Fund O, HoldCo and Common Parent, respectively). Where the entity under audit is an investment company or investment adviser within a private equity firm (or other type of investment company complex), a similar analysis would be necessary to determine the status of other entities as potential affiliates under the revisions to the investment company complex definition contemplated by Rule 2-01(f)(14)(i)(D).

The ultimate result is that if adopted as proposed, in practical terms, amended Rule 2-01(f)(4)(i)(B) and Rule 2-01(f)(14)(i)(D) would not provide effective relief for private equity firms and portfolio companies, due to the complex and ever-evolving nature of the materiality determination that would be required on an ongoing basis. Equally important is that, even if it were practicable to track these materiality determinations in real time, the proposed amendments would not provide meaningful relief. The fact that the materiality determination can change due to circumstances extraneous to either PortCo W or PortCo X, or to any number of investment advisers and funds within a private equity firm, means that the practical result under the proposed amendments would be the same as it is today: to avoid an independence violation, either the entity under audit would need to change its auditor, or its sister entity would need to terminate non-audit services and business relationships.

For these reasons, the AIC strongly encourages the SEC to further amend proposed Rule 2-01(f)(4)(i)(B) and Rule 2-01(f)(14)(i)(D) to provide that, consistent with the AICPA Code and IESBA Code, an entity which is under common control with the audit client will be considered an affiliate of the audit client only if both the entity under audit and the commonly controlled entity are material to the entity that controls both. In the above example, this additional materiality threshold would still require a determination at each stage of whether PortCo W is material to Advisor B. However, if it is determined that PortCo W is immaterial to Advisor B, neither the other funds advised by Advisor B nor their respective portfolio companies would be considered affiliates of PortCo W, thereby alleviating an otherwise burdensome analysis of other entities in the private equity firm and the portfolio companies of its funds. The extended analysis would need to be conducted in the case that PortCo W is, in fact, material to Advisor B, but the introduction of this additional materiality threshold would significantly reduce the regularity of such analyses, and generally make it much less likely that the frequent transactions and fundraising activities conducted by private equity firms would impact any given audit client that is part of a private equity firm or a portfolio company of a fund within a private equity firm.

In contrast to weakening the Commission's independence standard, the AIC believes that these changes to Rule 2-01(f)(4)(i)(B) and Rule 2-01(f)(14)(i)(D) could have an enhancing effect. Shifting the nexus of the independence analysis incrementally away from bright-line, difficult-to-administer rules, and toward a meaningful qualitative and quantitative assessment that necessarily considers materiality in a substantive fashion, would lead to numerous beneficial outcomes, by:

- Enhancing engagement of, and collaboration between, the parties involved in the financial statement audit process, because the internal leadership, audit committee, and external auditors of the entity under audit would have the opportunity to share views and perspectives, providing a solid foundation for an ongoing conversation that strengthens two-way communication and improves mutual understanding;

- Helping private equity firms and their portfolio companies to identify and build an understanding of the key issues around materiality and auditor independence, in turn strengthening internal buy-in and improving disclosure to shareholders about the qualification of the selected auditor;

- Informing the ongoing risk assessment and oversight that are fundamental to safeguarding the auditor's objectivity, impartiality and willingness and ability to raise issues;

- Providing companies with greater choice in their selection of independent auditors, serving as a safeguard against systemic problems, and in their selection of non-audit service providers, promoting market competition to the benefit of investors; and

- Promoting efficiency by conforming the treatment of sister portfolio companies under Rule 2-01(f) more closely to the approach taken by the AICPA Code and IESBA Code.

The AIC urges the Commission to consider these benefits, which we believe are consistent with the Commission's mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation.

Finally, we recommend that the Commission amend proposed Rule 2-01(f)(14)(i)(C) such that when the entity under audit is an investment company within an investment company complex, an operating company owned by another investment company advised by the same investment adviser to the investment company under audit would not be considered an affiliate of the audit client. Again, an example may be helpful. Referring again to the hypothetical structure chart above, suppose that Fund O is the audit client.

Suppose further that PortCo Y, a controlled portfolio company of Fund P, is not an investment company, investment adviser or service provider described in proposed Rule 2-01(f)(14)(D)(2). If PortCo Y is not material to Adviser B, then it would not be an affiliate of Fund O under proposed Rule 2-01(f)(14)(D). However, because Adviser B controls Fund P, and Fund P controls PortCo Y, PortCo Y would be an affiliate of Fund O under proposed Rule 2-01(f)(14)(C), a result that appears inconsistent with the manner in which the amendments contemplated by the Proposing Release otherwise would apply to sister entities.

4. ***The AIC recommends further amending proposed Rule 2-01(f)(4)(i) and Rule 2-01(f)(14)(i)(C) to provide that an entity which is a direct or indirect controlling entity of the entity under audit will be considered an affiliate of the entity under audit only if the entity under audit is material to the direct or indirect controlling entity.***

Under both the AICPA Code and the IESBA Code, direct and indirect controlled downstream entities from an entity under audit are considered affiliates (or "related entities" in the case of the IESBA Code) of the entity of audit. Upstream entities, however, are not considered affiliates of an entity under audit unless the upstream entity has direct or indirect control over, or a direct financial interest in and significant influence over, the entity under audit, and, in each case, the entity under audit is "material" to the upstream entity. By contrast, under both current Rule 2-01(f)(4) and Rule 2-01(f)(14) and the changes contemplated by the Proposing Release, direct or indirect controlling entities of an entity under audit are considered affiliates, regardless of the materiality of the entity under audit to its parent.

The AIC urges the Commission to consider amending Rule 2-01(f)(4) and Rule 2-01(f)(14) to conform to the treatment of upstream affiliates under the AICPA Code and IESBA Code. In addition to attaining the benefits of materiality assessments described above (as contrasted to bright-line rules), such changes would also be more consistent with the nature of the relationship between a private equity firm, on the one hand, and its portfolio companies, on the other hand. In contrast to the relationship between a traditional operating company and its subsidiaries, private equity firms take ownership of portfolio companies with a view toward improving them (e.g., through operational enhancements or combination with other companies) and ultimately engaging in a disposition such as a sale or IPO, with the realized proceeds (after expenses and carried interest) being distributed to fund investors. Even during the period of ownership, the private equity firm's relationship with its portfolio companies typically is significantly more arm's-length in nature (and often constrained by the terms of an operating agreement) than the relationship between an operating company and its consolidated subsidiaries. Focusing on the materiality of a portfolio company to its parent entities within a private equity firm, rather than strictly on a control analysis that does not reflect the actual nature of the private equity model, would more accurately align Rule 2-01 with the day-to-day reality of how private equity firms and their portfolio companies typically interact.

5. ***The AIC supports the Commission's proposed amendments to Rule 2-01(c)(3) to replace the reference to "substantial stockholders" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client", but recommends that the Commission consider clarifications conforming to the Loan Provision so that entities under common control with, or controlled by, a beneficial owner with significant influence, are excluded from the scope of the business relationship rule.***

In the 2018 AIC Letter, we expressed support for the shift to a "significant influence" standard under Rule 2-01(c)(3), noting that:

> [U]nder the current Independence Rules, business relationships are broadly defined and, in many cases, can be construed to apply to relationships that present no reasonable threat to objectivity and impartiality in the conduct of an audit. This results not only from the expansive incorporation of affiliates into the term "audit client," but also from the fact that the terms "substantial stockholder" and "indirect relationship" are not defined in the Independence Rules. The result is that significant resources are expensed by issuers, accounting firms and audit committees to evaluate and track many relationships that pose no risk to investors regarding auditor objectivity and impartiality.

Thus, the AIC supports the Commission's proposal to incorporate a "significant influence" standard rather than a "substantial stockholder" standard under in Rule 2-01(c)(3).

In addition, the AIC recommends the Commission consider clarifying, similarly to the Loan Provision, that entities under common control with, or controlled by, a beneficial owner with significant influence are excluded from the scope of the business relationship rule. We note that, in the Loan Provision Adopting Release, the Commission stated 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 Loan Provision."[14] The AIC believes that conforming this portion of the business relationship rule to the Loan Provision will increase auditor choice and consistency, while reducing complexity, as the private equity firm and its portfolio companies strive to comply with the Commission's independence requirements.

Further, we note the Commission's request for comment on "multi-company arrangements." Specifically, the Proposing Release refers to the Commission's understanding 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."[15] The Proposing Release requests comment on whether there are instances where such arrangements would not impair an auditor's objectivity and impartiality, even after the amendments contemplated by the Proposing Release.

The AIC agrees that such arrangements with accounting firms are of increasing importance, particularly to companies active in technology and related industries. Many technology firms maintain relationships with accounting firms, particularly the "Big 4," in order to develop and distribute their products, including cloud hosting and computing services, online data rooms, development tools and analytical software, among many others. These firms frequently require growth capital or seek to combine with other firms in order to aggregate technologies, integrate vertically or achieve critical market scale. Private equity firms are often in a position to provide such capital or facilitate transactions between companies. However, where such technology firms have business relationships with accounting firms, the ability of private equity firms to provide such assistance is frequently hindered by Rule 2-01(c). For example, suppose TechCo T is a technology company that provides business process software, and that TechCo T has an agreement with Accountant A under which TechCo T provides software to clients of Accountant A in connection with Accountant A's information systems consulting services. If Accountant A is the independent auditor to a portfolio company of a private equity firm, PortCo Z, then in order for the private equity firm to acquire TechCo T, the current business relationships rule would either require TechCo T to terminate its relationship with Accountant A, or require Portco Z to find a new auditor. In practice, having "no good

[14] Loan Rule Adopting Release, at 20.

[15] Proposing Release, at 38.

option" under such circumstances often means that a private equity firm — or in some cases, many private equity firms — are precluded from investing in such technology companies.

The amendments to Rule 2-01(c)(3) currently contemplated by the Proposing Release would do little to address the situation described above. This is in part because, under the business relationships rule, an accounting firm is not independent if it has any direct or material indirect business relationship with an "audit client," which term includes "affiliates" of the audit client. If amended as proposed, in practice the definition of "audit client" will continue to include entities under common control as affiliates, regardless of the addition of a materiality qualifier, for the reasons discussed in comment 3 above. By contrast, if the definition of "affiliate of the audit client" is amended to require both the entity under audit and its sister entity to be "material" to the common parent in order for there to be affiliation between commonly controlled entities, the AIC believes that the burden that the business relationship rule imposes on such entities would be significantly alleviated.

6. ***The AIC requests that the Commission (a) provide additional guidance on the determination of materiality by private equity firms in the context of Rule 2-01, (b) consider defining "controlling entity" for purposes determining affiliation under Rule 2-01 to mean the ultimate controlling entity of a private equity firm, (c) clarify the obligations of accounting firms and their clients in assessing the application of the standard in Rule 2-01(b) to certain entities that would no longer be considered "affiliates of the audit client" under the amended rule and (d) support any efforts by the PCAOB to conform its independence rules in light of the amendments to Rule 2-01 that are ultimately adopted by the Commission.***

The AIC recommends that the Commission (or its Staff) consider providing additional guidance on the analysis of "materiality" for purposes of Rule 2-01. We understand that accounting firms currently assess materiality using a combination of qualitative and quantitative factors, derived from guidance and standards set forth by the Commission and the Staff as well as standards-setting bodies such as PCAOB and AICPA. Particularly in the context of private equity investing and the evaluation of auditor independence, we believe that any further guidance should be flexible in nature to account for the diversity of situations that firms encounter, and allow qualitative and quantitative factors to be taken to account.

The AIC further encourages the Commission to consider amending Rule 2-01 (or issuing interpretive guidance) to provide that, with respect to the determination of affiliation under Rule 2-01(f)(4) and Rule 2-01(f)(14) by private equity firms, "controlling entity" means the private equity firm's ultimate controlling entity. As our examples in this letter indicate, a major source of complexity in the application of Rule 2-01 for private equity firms and their accountants is the fluctuating nature of the funds, investment advisers, and other direct and indirect intermediate controlling entities that exist between the portfolio companies at the bottom of the chain of ownership and the ultimate parent entity of the private equity firm at the top. As a result, the determination of the commonly controlling entity for any particular set of two or more sister portfolio companies or entities within the firm is, in practical effect, arbitrary. By contrast, the authority to determine the firm's accounting, financial, operational and other policies generally resides with the top-level parent entity. In such circumstances, we believe that it would be more appropriate and consistent with the Commission's mission to evaluate the materiality of an audit client and its sister entities with respect to the private equity firm as a whole, rather than with respect to the entity that most directly happens to control the audit client and its sister entities at a given point in time.

In addition, throughout this letter we have assumed that for purposes of applying the general standard of auditor independence in Rule 2-01(b), the rule would not require continuous, entity-by-entity analysis of an auditor's relationships with all entities that are included within a private entity firm as well as its portfolio

companies when those entities are not themselves "affiliates" of the entity under audit. This appears to be supported by the Commission's statement in the Proposing Release that "[f]or the relationships and services that might nevertheless impact the auditor's independence under the general standard in Rule 2-01(b), [the Commission] would expect those relationships and services individually or in the aggregate would be easily known by the auditor and the audit client because such services and relationships are most likely to threaten an auditor's objectivity and impartiality due to the nature, extent, relative importance or other aspects of the service or relationship." While we interpret this statement to imply that relationships and services that impair independence under Rule 2-01(b) (and are not otherwise addressed by Rule 2-01(c)) can reasonably be identified without requiring an entity-by-entity analysis, we recommend that the Commission provide clarification. In this regard, we note that the "knows or has reason to believe" standard utilized in the AICPA Code would serve as a useful measure that is well understood among accounting firms and their clients and could easily be extended with respect to the manner of application of Rule 2-01(b).

Finally, we note that under PCAOB Rule 3500T, to the extent that a provision of Rule 2-01 is more restrictive, or less restrictive, than the PCAOB's independence standards, a registered public accounting firm must comply with the more restrictive rule. To the extent that the Commission ultimately adopts amendments to Rule 2-01, we encourage the Commission to support any necessary amendments to PCAOB rules in order to bring them into consistency with the letter and spirit of the Commission's amendments.

* * *

In conclusion, we appreciate the opportunity to submit this comment letter, and applaud the Commission's efforts to better align the auditor independence requirements of Rule 2-01 with the Commission's mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. We believe that, with the modifications proposed above, the changes contemplated in the Proposing Release will enhance market efficiency and increase auditor choice for private equity firms and other stakeholders. Given the importance of this topic to the private equity and broader asset management industries, the AIC and its member firms would welcome the opportunity to further discuss our comments, experiences and potential solutions with the Commission and its Staff.

Respectfully submitted,

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