

# SECURITIES AND EXCHANGE COMMISSION

## 17 CFR Part 210

[Release No. 33-10876; 34-90210; FR-88; IA-5613; IC-34052; File No. S7-26-19]

RIN: 3235-AM63

### Qualifications of Accountants

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission” or “SEC”) is adopting amendments to update certain auditor independence requirements. These amendments are intended 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.

**DATES:** *Effective date:* [INSERT DATE 180 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

*Compliance dates:* See Section II.G for further information on transitioning to the final amendments.

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**SUPPLEMENTARY INFORMATION:** We are adopting amendments to 17 CFR 210.2-01

(“Rule 2-01”) of 17 CFR 210.01 *et seq.* (“Regulation S-X”).<sup>1</sup>

**Table of Contents**

I.	INTRODUCTION .....	3
II.	AMENDMENTS .....	6
A.	Amendments to Definitions .....	6
1.	Amendments to the Definitions of Affiliate of the Audit Client and the Investment Company Complex .....	6
2.	Amendment to the Definition of Audit and Professional Engagement Period .....	48
B.	Amendments to Loans or Debtor-Creditor Relationships .....	53
1.	Amendment to Except Student Loans.....	53
2.	Amendment to Clarify the Reference to “A Mortgage Loan” .....	57
3.	Amendment to Revise the Credit Card Rule to Refer to “Consumer Loans” .....	59
C.	Amendments to the Business Relationships Rule.....	62
1.	Proposed Amendment to the Reference to “Substantial Stockholder” .....	62
2.	Comments Received .....	64
3.	Final Amendments .....	66
4.	Conforming Amendments to the Loan Provision .....	68
D.	Amendments for Inadvertent Violations for Mergers and Acquisitions.....	69
1.	Proposed Amendment .....	69
2.	Comments Received .....	70
3.	Final Amendments .....	74
E.	Miscellaneous Amendments .....	79
1.	Proposed Miscellaneous Amendments .....	79
2.	Comments Received .....	80
3.	Final Amendments .....	80
F.	Other Comments Received .....	80
G.	Transition .....	81
III.	OTHER MATTERS.....	82
IV.	ECONOMIC ANALYSIS .....	82

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<sup>1</sup> Hereinafter, all references to Rule 2-01 and any paragraphs included within the rule refer to Rule 2-01 of Regulation S-X.

A.	Introduction.....	82
B.	Baseline and Affected Parties .....	84
C.	Potential Costs and Benefits .....	89
1.	Overall Potential Costs and Benefits .....	89
2.	Costs and Benefits of Specific Amendments.....	92
a.	Amendments to the Definition of an Affiliate of the Audit Client and Investment Company Complex .....	93
b.	Amendment to the Definition of Audit and Professional Engagement Period.....	100
c.	Amendments to Loans or Debtor-Creditor Relationships .....	103
d.	Amendments to the Business Relationships Rule.....	104
e.	Amendments for Inadvertent Violations for Mergers and Acquisitions.....	105
D.	Effects on Efficiency, Competition and Capital Formation.....	107
E.	Alternatives .....	109
V.	PAPERWORK REDUCTION ACT.....	112
VI.	FINAL REGULATORY FLEXIBILITY ACT ANALYSIS .....	113
A.	Need for, and Objectives of, the Final Amendments.....	113
B.	Significant Issues Raised by Public Comment .....	114
C.	Small Entities Subject to the Proposed Rules .....	114
D.	Projected Reporting, Recordkeeping and Other Compliance Requirements.....	117
E.	Agency Action to Minimize Effect on Small Entities .....	119
VII.	CODIFICATION UPDATE .....	121
VIII.	STATUTORY BASIS .....	121

## I. INTRODUCTION

On December 30, 2019, the Commission proposed amendments to Rule 2-01 to update certain auditor independence requirements, including by focusing the requirements on those relationships and services that are more likely to threaten an auditor’s objectivity and impartiality in light of current market conditions and industry practice.<sup>2</sup> Specifically, the Commission

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<sup>2</sup> *Amendments to Rule 2-01, Qualifications of Accountants*, Release No. 33-10738, Dec. 30, 2019 [85 FR 2332 (Jan. 15, 2020)] (the “Proposing Release”).

proposed amendments to the definitions of “affiliate of the audit client,” “investment company complex,” and “audit and professional engagement period” in Rule 2-01. The Commission also proposed amending requirements relating to certain loans or debtor-creditor relationships in 17 CFR 210.2-01(c)(1) (“Rule 2-01(c)(1)”) and the reference to “substantial stockholders” in 17 CFR 210.2-01(c)(3) (“Rule 2-01(c)(3)”) and the “Business Relationships Rule”). Finally, the Commission proposed amendments to address inadvertent violations of the independence requirements as a result of mergers and acquisitions and to make certain miscellaneous updates.

The Commission has long recognized that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence.<sup>3</sup> If investors do not perceive that the auditor is independent from the audit client, investors will derive less confidence from the auditor’s report and the audited financial statements. As such, the Commission’s auditor independence rule, as set forth in Rule 2-01, requires auditors<sup>4</sup> to be independent of their audit clients both “in fact and in appearance.”<sup>5</sup>

As the Commission noted in the Proposing Release, except for revisions made in connection with amendments required by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley

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<sup>3</sup> See *Revision of the Commission’s Auditor Independence Requirements*, Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] (“2000 Adopting Release”).

<sup>4</sup> We use the terms “accountants” and “auditors” interchangeably in this release.

<sup>5</sup> See current Preliminary Note 1 to §210.2-01 and 17 CFR 210.2-01(b) (“Rule 2-01(b)”). See also *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984) (“It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation’s financial statements depends upon the public perception of the outside auditor as an independent professional.”).

Act”)<sup>6</sup> and the recent amendments related to certain debtor-creditor relationships,<sup>7</sup> many of the provisions from the 2000 Adopting Release have remained unchanged since adoption. The amendments we are adopting maintain the bedrock principle that auditors must be independent in fact and in appearance while improving the relevance of the Commission’s auditor independence standards in light of existing market conditions by more effectively focusing the independence analysis on those relationships or services that are more likely<sup>8</sup> to threaten an auditor’s objectivity and impartiality.

Many commenters broadly supported the objectives of the proposed amendments or were generally in favor of the proposals.<sup>9</sup> A few commenters did not support the proposals.<sup>10</sup> One of these commenters expressed the view that the proposals could negatively affect investor

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<sup>6</sup> See *Strengthening the Commission’s Requirements Regarding Auditor Independence*, Release No. 33-8183 (Jan. 28, 2003) [68 FR 6005 (Feb. 5, 2003)].

<sup>7</sup> See *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release 33-10648 (June 18, 2019) [84 FR 32040 (July 5, 2019)] (“Loan Provision Adopting Release”). In this release, references to the “Loan Provision” mean 17 CFR 210.2-01(c)(1)(ii)(A) (“Rule 2-01(c)(1)(ii)(A)”).

<sup>8</sup> As compared to the relationships and services that are deemed independence-impairing under existing Rule 2-01, but are unlikely to threaten an auditor’s objectivity and impartiality and would no longer be deemed independence-impairing pursuant to the final amendments.

<sup>9</sup> See, e.g., letters from American Investment Council (Mar. 16, 2020) (“AIC”), Investment Company Institute and Independent Directors Council (Mar. 16, 2020) (“ICI/IDC”), EQT AB (Mar. 13, 2020) (“EQT”), Financial Executives International (Mar. 16, 2020) (“FEI”), Center For Capital Markets Competitiveness – U.S. Chamber of Commerce (Mar. 16, 2020) (“CCMC”), National Association of State Boards of Accountancy (Feb. 25, 2020) (“NASBA”), New York State Society of Certified Public Accountants (Mar. 13, 2020) (“NYSSCPA”), Center for Audit Quality (Mar. 16, 2020) (“CAQ”), American Institute of Certified Public Accountants (Mar. 16, 2020) (“AICPA”), Deloitte LLP (Mar. 4, 2020) (“Deloitte”), BDO USA, LLP (Mar. 10, 2020) (“BDO”), Ernst & Young LLP (Mar. 13, 2020) (“EY”), KPMG LLP (Mar. 13, 2020) (“KPMG”), RSM LLP (Mar. 16, 2020) (“RSM”), PricewaterhouseCoopers LLP (Mar. 16, 2020) (“PwC”), Grant Thornton LLP (Mar. 16, 2020) (“GT”), Crowe LLP (Mar. 16, 2020) (“Crowe”), and William G. Parrett (Mar. 16, 2020) (“Parrett”). The comment letters on the Proposing Release are available at <https://www.sec.gov/comments/s7-26-19/s72619.htm>.

<sup>10</sup> See, e.g., letters from Council of Institutional Investors (Mar. 16, 2020) (“CII”), Consumer Federation of America (May 4, 2020) (“CFA”), Center for American Progress, *et al* (May 26, 2020) (“CAP”), and Roy T. Van Brunt (July 23, 2020) (“Van Brunt”).

protection and capital formation and suggested that, in lieu of the proposals, more should be done to strengthen auditor independence standards and the enforcement of such standards.<sup>11</sup>

While commenters were largely supportive of the proposals, we also received recommendations for modifying or clarifying certain aspects of the proposed amendments. After reviewing and considering the public comments and recommendations received, we are adopting the amendments largely as proposed. As we discuss further below, in certain cases we are adopting the proposed amendments with modifications that are intended to address comments received.

## **II. AMENDMENTS**

### **A. Amendments to Definitions**

#### **1. Amendments to the Definitions of Affiliate of the Audit Client and the Investment Company Complex**

The term “audit client”<sup>12</sup> is defined as “the entity whose financial statements or other information is being audited, reviewed or attested”<sup>13</sup> and “any affiliates of the audit client.”<sup>14</sup>

The current definition of affiliate of the audit client includes, in part, “[a]n entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client’s parents and subsidiaries” and

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<sup>11</sup> See letter from CFA.

<sup>12</sup> 17 CFR 210.2-01(f)(6) (“Rule 2-01(f)(6)”).

<sup>13</sup> The term “entity under audit” as used herein and in the final amendments refers to this part of the Rule 2-01(f)(6) definition of audit client.

<sup>14</sup> See Rule 2-01(f)(6). For purposes of 17 CFR 210.2-01(c)(1)(i) (“Rule 2-01(c)(1)(i)”) (*Investments in Audit Clients*), entities covered by 17 CFR 210.2-01(f)(4)(ii) (“Rule 2-01(f)(4)(ii)”) or 17 CFR 210.2-01(f)(4)(iii) (“Rule 2-01(f)(4)(iii)”) are not considered affiliates of the audit client, as they are already addressed by 17 CFR 210.2-01(c)(1)(i)(E).

“[e]ach entity in the investment company complex when the audit client is an entity that is part of an investment company complex.”<sup>15</sup>

Under current Rule 2-01, the requirement to identify and monitor for potential independence-impairing relationships and services applies to affiliated entities, including sister entities,<sup>16</sup> regardless of whether the sister entities are material to the controlling entity.<sup>17</sup> This same requirement to identify and monitor for potential independence-impairing relationships and services applies to entities, including sister entities that are part of an investment company complex (“ICC”).<sup>18</sup>

The Proposing Release noted the challenges in practical application that are associated with the current definitions of affiliate of the audit client and ICC.<sup>19</sup> In particular, the Proposing Release noted how these definitions can result in relationships with and services to certain sister entities that are less likely to threaten an auditor’s objectivity and impartiality being deemed independence-impairing under our rules.<sup>20</sup> To address those challenges, the Commission proposed amendments to the definitions of both affiliate of the audit client and ICC. After considering the public comments and recommendations received, we are adopting amendments to both definitions with modifications, as discussed in further detail below.

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<sup>15</sup> 17 CFR 210.2-01(f)(4)(i) (“Rule 2-01(f)(4)(i)”) and 17 CFR 210.2-01(f)(4)(iv) (“Rule 2-01(f)(4)(iv)”).

<sup>16</sup> See 17 CFR 210.2-01(f)(4) (“Rule 2-01(f)(4)”) and Rule 2-01(f)(6). We use the term “sister entities” to refer to entities that are under common control with the entity under audit.

<sup>17</sup> See Rule 2-01(f)(4).

<sup>18</sup> *Id.* and 17 CFR 210.2-01(f)(14) (“Rule 2-01(f)(14)”).

<sup>19</sup> See Section II.A.1 of the Proposing Release.

<sup>20</sup> *Id.*

**a. Amendments with Respect to Common Control and Affiliate of the Audit Client**

**i. Proposed Amendments**

The Commission proposed amending the definition of an affiliate of the audit client set forth in Rule 2-01(f)(4)(i) to include a materiality qualifier with respect to operating companies, including portfolio companies, under common control<sup>21</sup> and to clarify the application of this definition to operating companies and direct auditors of an investment company or investment adviser or sponsor to the ICC definition.<sup>22</sup> In the Proposing Release, the Commission discussed challenges related to applying the current affiliate of the audit client and ICC definitions, including challenges related to the limited pool of available qualified auditors, ongoing monitoring for independence, and related costs.<sup>23</sup>

Under the proposal, a sister entity would be deemed an affiliate of the audit client “unless the entity is not material to the controlling entity.” The Proposing Release set forth the Commission’s view that it is appropriate to exclude sister entities that are not material to the controlling entity from being considered affiliates of the audit client because an auditor’s relationships and services with such sister entities do not typically pose a threat to the auditor’s

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<sup>21</sup> See Proposed Rule 2-01(f)(4)(i)(B).

<sup>22</sup> See Proposed Rule 2-01(f)(4)(ii). Specifically, the “and” between the second significant influence provision would be replaced by an “or.” Consistent with footnote 18 of the Proposing Release, the term “operating company” in this release refers to entities that are not investment companies, investment advisers, or sponsors, and the term “portfolio company” refers to an operating company that has investment companies or unregistered funds in private equity structures among its investors. In Section II.A.1.a of the Proposing Release, the Commission expressed its belief that it would be appropriate to identify the affiliates of the audit client for a portfolio company under audit using the proposed affiliate of the audit client definition, rather than the proposed ICC definition, because portfolio companies are a type of operating company that are often unrelated to each other, even though they are controlled by the same entity in the private equity structure or ICC.

<sup>23</sup> See Section II.A.1.a of the Proposing Release.



objectivity and impartiality and their exclusion would allow auditors and audit clients to focus on those relationships that are more likely to threaten the auditor’s objectivity and impartiality.

The Proposing Release noted that materiality is applied in the existing affiliate of the audit client definition in Rules 2-01(f)(4)(ii) and (iii)<sup>24</sup> and that the proposed materiality qualifier would be consistent, in part, with the definition of “affiliate” used by the American Institute of Certified Public Accountants (“AICPA”) in its ethics and independence rules.<sup>25</sup> The AICPA ethics and independence rules typically apply when domestic companies are not also subject to the Commission and PCAOB independence requirements. Auditors therefore have experience in applying a materiality standard when identifying affiliates, whether applying the independence rules of the Commission or the AICPA.

## ii. Comments Received

Commenters generally supported the proposed changes to the definition of the affiliate of the audit client.<sup>26</sup> Consistent with the discussion in the Proposing Release, commenters

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<sup>24</sup> Rule 2-01(f)(4)(ii) includes as an affiliate of the audit client “an entity over which the audit client has significant influence, unless the entity is not material to the audit client.” Rule 2-01(f)(4)(iii) includes as an affiliate of the audit client “an entity that has significant influence over the audit client, unless the audit client is not material to the entity.”

<sup>25</sup> See AICPA Professional Code of Conduct, *available at* <https://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf>. The Proposing Release acknowledged that the proposed amendment may not result in the same number of sister entities being deemed material to the controlling entity under Commission rules and the AICPA rules. For example, in defining control, the AICPA uses the accounting standards adopted by the Financial Accounting Standards Board (“FASB”), whereas the Commission defines control in Rule 1-02(g) of Regulation S-X. Also, the AICPA affiliate definition pertaining to common control deems a sister entity as an affiliate if the entity under audit and the sister entity are each material to the entity that controls both. The proposed amendment only focused on the materiality of the sister entity to the controlling entity.

<sup>26</sup> See *e.g.*, letters from Illinois CPA Society (Feb. 21, 2020) (“Illinois CPA”), SEC Professional Group (Feb. 25, 2020) (“SEC Pro Group”), International Bancshares Corporation (“Mar. 13, 2020”) (“IBC”), NASBA, CAQ, AICPA, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, Parrett, AIC, ICI/IDC, EQT, FEI, and CCMC.

discussed the challenges presented by the current definitions (*e.g.*, cost, difficulty of application, and impact on the available pool of qualified auditors) and agreed that introducing a materiality qualifier into the analysis would better focus the analysis on threats to an auditor’s objectivity and impartiality and address some of those challenges.<sup>27</sup>

A few commenters opposed the proposed materiality qualifier to the affiliate of the audit client definition.<sup>28</sup> These commenters asserted that introducing a materiality qualifier would increase the risk that auditors would be performing audits when they are not objective and impartial, noting that there is evidence that auditors’ materiality judgments vary widely.<sup>29</sup> One of these commenters suggested that the Commission “examine the evidence before changing its current approach.”<sup>30</sup>

In addition to these comments on the proposed amendments, we also received feedback on additional changes to the definition of affiliate of the audit client and other related changes, as discussed in more detail below.

### **Comments Recommending a Dual Materiality Threshold**

Many commenters recommended that we further amend the common control provision in the affiliate of the audit client definition to add a materiality qualifier with respect to the entity

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<sup>27</sup> See *e.g.*, letters from Deloitte, GT, EQT, and CAQ.

<sup>28</sup> See *e.g.*, letters from CFA and CII. Both commenters expressed their disagreement regarding the proposed materiality qualifier within a discussion that covers both the affiliate of the audit client and the ICC definitions.

<sup>29</sup> See letters from CFA and CII (citing Katherine Schipper et al., *Auditors’ Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability*, 52 J. Acct. Res. 1303 (Dec. 2019), available at <https://onlinelibrary.wiley.com/doi/full/10.1111/1475-679X.12286>). See *infra* note 262 and accompanying text.

<sup>30</sup> See letter from CFA.

under audit to accompany the proposed materiality qualifier with respect to the sister entity (a “dual materiality threshold”).<sup>31</sup> This dual materiality threshold would result in a sister entity being deemed an affiliate of the audit client only if the entity under audit and the sister entity are each material to the controlling entity.<sup>32</sup>

These commenters stated that, when the entity under audit is not material to the controlling entity, services provided to or relationships with sister entities typically do not create threats to an auditor’s objectivity and impartiality.<sup>33</sup> For example, one commenter stated that, in its experience, the entity under audit and the sister entities typically have their own governance structures, which indicates that there is no mutuality of interest between the auditor and the audit client.<sup>34</sup> Another commenter stated that the proposed single materiality threshold would, in fact, “increase” the burden on private equity firms by requiring more time and resources to monitor the “continuously evolving universe of entities that the private firm would need to address...”<sup>35</sup> This commenter contended that in the event the entity under audit is not material to the controlling entity, a dual materiality threshold would alleviate the burdens associated with a materiality analysis that would otherwise have to be conducted on each sister entity.

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<sup>31</sup> See e.g., letters from CAQ, AICPA, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, Parrett, AIC, CCMC, New York State Society of Certified Public Accountants (Mar. 13, 2020) (“NYSSCPA”), and Connecticut Society of Certified Public Accountants (Apr. 15, 2020) (“CTCPA”). These commenters noted that analogous provisions exist in the AICPA and the International Ethics Standards Board for Accountants (“IESBA”) ethics and independence requirements.

<sup>32</sup> *Id.*

<sup>33</sup> See e.g., letters from BDO, Deloitte, EY, KPMG, PwC, Crowe, CTCPA, CCMC, and GT.

<sup>34</sup> See letter from Deloitte.

<sup>35</sup> See letter from AIC.

Commenters also suggested that because a dual materiality threshold is used by the AICPA and IESBA ethics and independence requirements, adopting a similar threshold would ease compliance burdens associated with the application of the affiliate definition and on-going monitoring for audit firms and clients.<sup>36</sup> A few commenters noted that any risks associated with a potential dual materiality threshold would be mitigated by the continued protections afforded by Rule 2-01(b).<sup>37</sup>

One commenter that opposed the proposed amendment noted that it also opposed the “double trigger threshold” of the AICPA.<sup>38</sup>

### **Other Comments on Materiality and Monitoring**

In response to a request for comment as to whether the proposed amendments should include a materiality assessment between the entity under audit and sister entities, commenters generally did not support adding such a provision.<sup>39</sup> For example, one commenter stated that concepts of financial materiality do not lend themselves to an evaluation of relationships between sister entities, and noted that if one entity had a material investment in the other, the other provisions of the affiliate of the audit client definition would address such a relationship.<sup>40</sup>

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<sup>36</sup> See e.g., letters from CAQ, Deloitte, BDO, RSM, PwC, CCMC, GT, and CTCPA.

<sup>37</sup> See e.g., letters from BDO, AICPA, AIC, and EY.

<sup>38</sup> See letter from CII. This commenter cited footnote 20 of the Proposing Release and indicated its agreement that requiring materiality between the entity under audit and the controlling entity may exclude, from the proposed definition, sister entities whose relationships with or services from an auditor would impair the auditor’s objectivity and impartiality.

<sup>39</sup> See e.g., letters from Deloitte, KPMG, RSM, and PwC.

<sup>40</sup> See letter from KPMG.

Some commenters suggested that a materiality qualifier also should be applied when considering whether an entity that has control over the entity under audit (*i.e.*, a controlling entity) is an affiliate under Rule 2-01(f)(4).<sup>41</sup> However, another commenter disagreed, stating that it believes parents and subsidiaries should continue to be affiliates regardless of materiality.<sup>42</sup>

In response to a request for comment as to whether auditors and audit clients would face challenges in applying the materiality concept in connection with the proposed amendment and whether additional guidance was needed, some commenters noted that the concept of materiality already exists within Rule 2-01, and as such, indicated that current materiality guidance is sufficient.<sup>43</sup> By contrast, other commenters suggested that there may be challenges in applying the materiality concept in connection with the proposed amendments,<sup>44</sup> and a few commenters requested additional guidance or examples.<sup>45</sup> One commenter suggested that to ease the burden of monitoring for compliance in connection with unforeseen changes in circumstances, the Commission should consider establishing a framework to allow auditors to address “inadvertent independence violations that might arise when a materiality threshold is crossed.”<sup>46</sup>

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<sup>41</sup> See *e.g.*, letters from CAQ, AICPA, Deloitte, BDO, Crowe, CTCPA, and AIC. See also *supra* 25. The relevant AICPA definition, 0.400.02, includes as an affiliate “[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” (emphasis in original).

<sup>42</sup> See letter from RSM.

<sup>43</sup> See *e.g.*, letters from Deloitte, EY, and Crowe.

<sup>44</sup> See *e.g.*, letters from NYSSCPA and PwC. For example, one commenter suggested the Commission define “controlling entity.” See letter from PwC.

<sup>45</sup> See *e.g.*, letters from NYSSCPA, CTCPA, and AIC.

<sup>46</sup> See letter from PwC.

Some commenters suggested that the Commission reiterate the shared responsibility of audit firms and their audit clients to monitor independence, including monitoring affiliates and obtaining information necessary to assess materiality.<sup>47</sup> One commenter recommended the Commission clarify that, once the initial materiality assessment has been made, the auditor and audit client could satisfy their obligations under the proposed amendments by reevaluating materiality in response to significant transactions, Commission filings, or other information that become known to the auditor or the audit client through reasonable inquiry.<sup>48</sup> Another commenter requested the Commission discuss expectations regarding best efforts to obtain information and monitoring if, for example, certain information can only be obtained annually.<sup>49</sup>

#### **Comments on “Entity under Audit”**

In the Proposing Release, the Commission used the term “entity under audit” to describe the application of the proposed amendments. The Commission explained that it was using this term to refer to the entity “whose financial statements or other information is being audited, reviewed or attested.”<sup>50</sup> The quoted language is the first clause of the definition of the term “audit client” in Rule 2-01(f)(6). Because the definition of audit client also includes any affiliates of the audit client, the Commission used the term “entity under audit” to describe those entities whose financial statements were subject to audit, review, or attestation, in an attempt to avoid the potential confusion that may arise from using the term “audit client.”

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<sup>47</sup> See e.g., letters from CAQ, PwC, and EY.

<sup>48</sup> See letter from Deloitte.

<sup>49</sup> See letter from GT.

<sup>50</sup> See footnote 11 of the Proposing Release and accompanying text.

In response to this discussion, some commenters suggested that Rule 2-01 incorporate more precise usage of the terms “audit client” and “entity under audit,” which may require defining the term “entity under audit.”<sup>51</sup> Several of those commenters recommended that the term “entity under audit” be included in the definition of affiliate of the audit client,<sup>52</sup> because the term “audit client,” which is defined to include affiliates in the definition of affiliate of the audit client, may cause confusion. One of these commenters characterized the reference to audit client in the existing affiliate of the audit client definition as a “circular reference.”<sup>53</sup>

### **Comments on “Controlling Entity” and “Control”**

While we did not propose any amendments to the term “control” as defined in 17 CFR 210.1-02(g) (“Rule 1-02(g)”) of Regulation S-X, a few commenters suggested that, for private equity firms, the term “controlling entity” should be defined as the overall private equity firm or the ultimate parent.<sup>54</sup> One of these commenters requested further explanation or guidance, such as through illustrative examples, to address whether the relationship between an investment adviser and a fund it advises should be treated as a control relationship and suggested that the term “control” should be linked to the accounting literature.<sup>55</sup> While these comments pertained to entities within an ICC, the comments are relevant when the entity under audit is not an

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<sup>51</sup> See e.g., letters from AICPA, Deloitte, EY, Crowe, PwC, and GT.

<sup>52</sup> See e.g., letters from AICPA, Deloitte, EY, and Crowe.

<sup>53</sup> See letter from Crowe.

<sup>54</sup> See e.g., letters from PwC and AIC.

<sup>55</sup> See letter from PwC.

investment company or investment adviser or sponsor, but the entity under audit controls or is controlled by an investment company or investment adviser or sponsor.<sup>56</sup>

### **iii. Final Amendments**

After considering the public comments and recommendations received, we are adopting amended 17 CFR 210.2-01(f)(4) (“amended Rule 2-01(f)(4)”) with certain modifications from the proposal, as described below. We considered the comments received opposing the addition of materiality to the common control provision, but continue to believe that materiality is an appropriate principle to effectively focus on relationships with and services provided to sister entities that are more likely to threaten an auditor’s objectivity and impartiality.

#### **Dual Materiality Threshold**

In response to comments, we are modifying the proposed amendments to Rule 2-01(f)(4)(ii) to incorporate a dual materiality threshold such that a sister entity will be included as an affiliate of the audit client if the sister entity and the entity under audit are each material to the controlling entity. Under the final amendments, if either the sister entity or the entity under audit is not material to the controlling entity, then the sister entity will not be deemed an affiliate of the audit client pursuant to amended 17 CFR 210.2-01(f)(4)(ii) (“amended Rule 2-01(f)(4)(ii)”).<sup>57</sup> In the Proposing Release, the Commission suggested that requiring that the entity under audit be material to the controlling entity as part of the proposed definition may exclude sister entities whose relationships with or services from an auditor would impair the auditor’s objectivity and impartiality.<sup>58</sup> However, after consideration of the comments received and further evaluation,

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<sup>56</sup> See *infra* Examples 3 and 4 in Section II.A.1.a.iii.

<sup>57</sup> We also are making a technical amendment to renumber the paragraphs within amended Rule 2-01(f)(4).

<sup>58</sup> See footnote 20 of the Proposing Release.



we are persuaded that where the entity under audit is not material to the controlling entity, an auditor's relationships with or services provided to sister entities would generally not threaten the auditor's objectivity and impartiality. In this regard, we agree that when the entity under audit is not material to the controlling entity, it is less likely that a mutuality of interest would develop as a result of relationships with or services provided to sister entities. For example, as one commenter observed, sister entities with separate governance structures, such as sister portfolio companies within an ICC, typically lack decision-making capacity over other sister entities, including an entity under audit.

We also recognize the benefit to auditors, audit clients, and investors of reducing compliance-related challenges. The adopted dual materiality threshold may help address some commenters' concerns about the inability to obtain all relevant information needed to make a materiality determination with respect to sister entities under the proposed single materiality threshold. Under the adopted dual materiality threshold, the need to assess the materiality relationship between the entity under audit and each of the controlling entities should reduce information access concerns because, in the event the entity under audit is not material to the controlling entity, the materiality assessment would be made for fewer sister entities as compared to the proposed single materiality threshold. However, as discussed in Section II.A.1.b.ii below, the auditor's non-audit services to and relationships with sister entities that are no longer deemed affiliates as a result of applying the dual materiality threshold will continue to be subject to the principles set forth in Rule 2-01(b), and as such, knowledge of services to and relationships with such non-affiliate sister entities will be needed to sufficiently consider the general standard.

Some commenters also suggested that we incorporate a materiality qualifier in the evaluation of whether controlling entities would be considered affiliates, similar to analogous

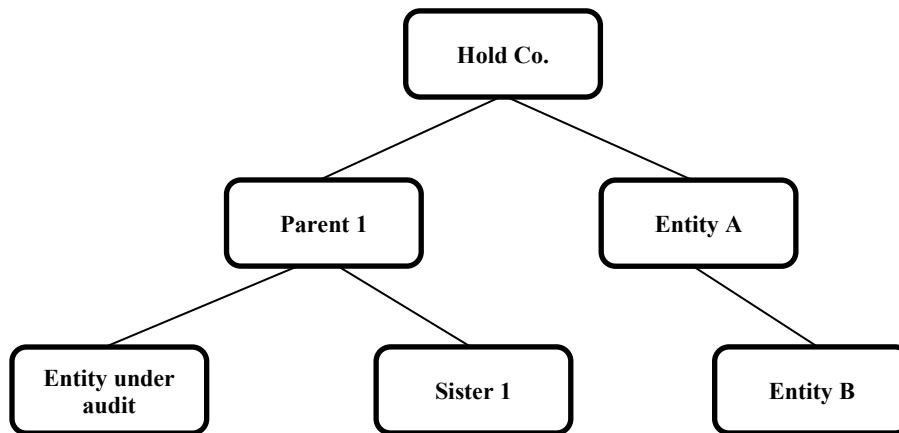
provisions in the AICPA and IESBA ethics and independence requirements. While commenters cited the benefits of having a common regime for the consideration of controlling entities, we were not persuaded that the benefits from such conformity would justify the potential risk to an auditor's objectivity and impartiality in these circumstances. In particular, commenters did not specifically highlight ongoing monitoring or other compliance challenges associated with the identification of affiliates that control an entity under audit. It does not appear that the challenges related to the changing population of potential affiliates and the ability to obtain appropriate information that occur in the common control context also exist when evaluating entities that have control over the entity under audit. In addition, the relationship between sister entities and an entity under audit is generally different than the relationship between a controlling entity and the entity under audit. The controlling entity typically has some decision-making ability or an ability to influence the entity under audit. As such, we believe an auditor's independence likely would be impaired if the auditor provides non-audit services to or engages in relationships with the controlling entity that are described in Rule 2-01(c), even in situations in which the entity under audit is not material to the controlling entity. Accordingly, we are not adopting commenters' recommendations to incorporate a materiality qualifier in the evaluation of whether controlling entities should be considered affiliates.

### **Entity under Audit**

We are making modifications to incorporate the term "entity under audit" within amended 17 CFR 210.2-01(f)(4)(i) ("amended Rule 2-01(f)(4)(i)") and amended 17 CFR 210.2-01(f)(4)(ii) ("amended Rule 2-01(f)(4)(ii)"). Given the comments received on this point and in light of other changes we are making to the final amendments, we believe it is appropriate to replace the term "audit client" with "entity under audit" in amended Rules 2-01(f)(4)(i) and (ii).

Specifically, as illustrated in the example below, we are concerned that if we do not revise this terminology, it could be applied in a manner that would negate the adopted dual materiality threshold.

Figure 1



In Figure 1, assume the controlling entities (*i.e.*, Parent 1 and Hold Co.) have control over all entities downstream from them. If amended Rules 2-01(f)(4)(i) and (ii) referred to an “audit client” instead of an “entity under audit,” Sister 1 may be deemed an affiliate of the audit client regardless of the materiality of Sister 1 or the Entity Under Audit to Parent 1 based on the following application:

- Parent 1 controls the entity under audit, which makes Parent 1 an affiliate of the audit client. Parent 1 also is an “audit client” because the definition of such term includes affiliates. A practitioner might then apply the control provision in amended Rule 2-01(f)(4)(i) to Parent 1 and deem Sister 1 an affiliate of the audit client, regardless of the dual materiality threshold. The practitioner would consider Sister 1 an affiliate because it is controlled by “audit client” Parent 1 without applying the materiality analysis in the common control provision of amended Rule 2-01(f)(4)(ii).

Similarly, Entities A and B may be deemed affiliates of the audit client regardless of the materiality of Entity A, Entity B, or the entity under audit to Hold Co. based on the following application:

- Under the existing and amended rules, Hold Co. is an affiliate of the audit client (*i.e.*, Hold Co. has control over the entity under audit) and, as such, also is an audit client. A practitioner might then apply the control provision in amended Rule 2-01(f)(4)(i) to Hold Co. and deem both Entities A and B as affiliates of the audit client, regardless of the dual materiality threshold in amended Rule 2-01(f)(4)(ii). Again, the practitioner may deem Entities A and B to be affiliates because “audit client” Hold Co. controls both Entities A and B.<sup>59</sup>

Absent clarification, the above-illustrated application (*i.e.*, circular reading) of the final amendments could negate the Commission’s objective to focus the common control provision on those relationships and services that are more likely to threaten the objectivity and impartiality of an auditor by introducing a dual materiality threshold. While the proposal did not use the term “entity under audit” in the rule text, we believe this modification is consistent with the proposal to separate out common control from existing Rule 2-01(f)(4)(i) and include a materiality provision within the definition. Now that the amended common control provision includes a dual materiality threshold, we believe the modification to use the term “entity under audit” in place of the term “audit client” in amended Rules 2-01(f)(4)(i) and (ii) is important to avoid any

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<sup>59</sup> Relatedly, when assessing whether Entities A and B are affiliates under amended Rule 2-01(f)(4)(ii), it may otherwise be unclear to a practitioner assessing materiality of the “audit client” whether such assessment applies to the entity under audit or an affiliate (such as Parent 1).

misunderstandings about how the common control provision should be applied in the final amendments.

While some commenters requested that we further amend our rules to incorporate more precise usage of the term “entity under audit”<sup>60</sup> in other paragraphs that currently refer to the “audit client,” those requests are beyond the scope of this rulemaking. We did not propose or seek comment on those particular amendments. Moreover, those additional amendments are not necessary to effectuate any aspect of the proposal. As such, we are not incorporating the term “entity under audit” into other paragraphs of the rule that currently refer to “audit client,” including the significant influence provisions of amended 17 CFR 210.2-01(f)(4)(iii) (“amended Rule 2-01(f)(4)(iii)”) and 17 CFR 210.2-01(f)(4)(iv) (“amended Rule 2-01(f)(4)(iv)”). However, the incorporation of “entity under audit” in amended Rules 2-01(f)(4)(i) and (ii), while leaving the term “audit client” within the significant influence provisions in amended Rules 2-01(f)(4)(iii) and (iv), does not imply a change from the historical practical application of these provisions, which has focused and should continue to focus on the entity under audit.

### **Assessing Materiality and Monitoring**

Several commenters requested clarification and examples of the application of the proposed amendments, including the proposed materiality qualifier. In response, we are providing several examples to illustrate the application of the final amendments to particular fact patterns.

Auditors and their audit clients have a shared responsibility to monitor independence in order to satisfy, as applicable, the requirements of the federal securities laws, including Rule 2-

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<sup>60</sup> See *supra* note 51.

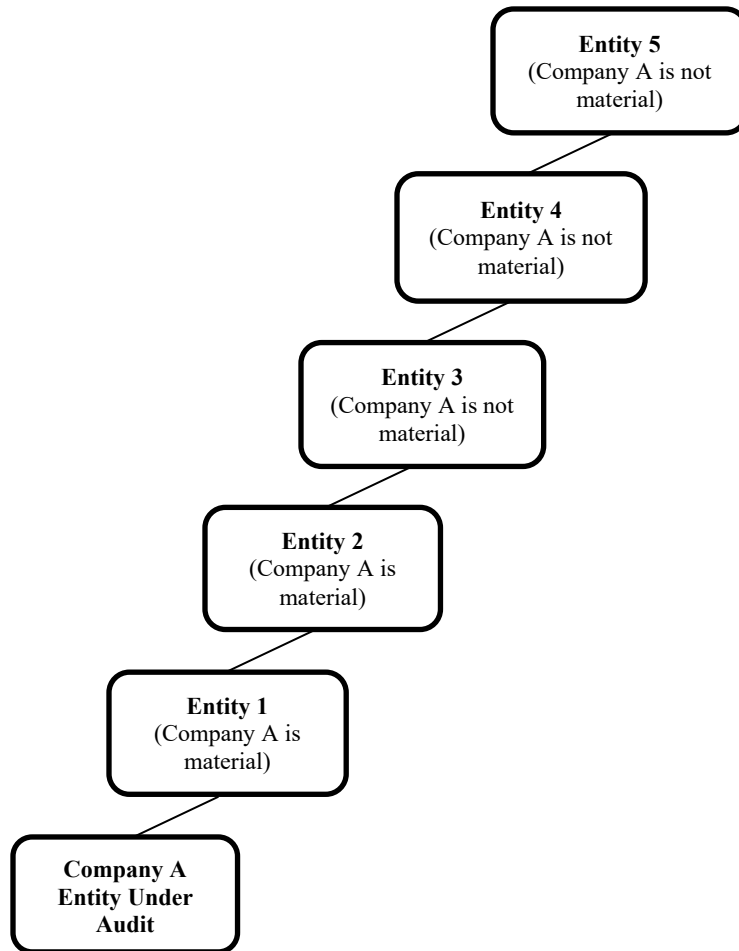
01 and 17 CFR 210.2-02.<sup>61</sup> This shared responsibility between auditors and audit clients applies to all aspects of Rule 2-01, including the final amendments. This responsibility includes the monitoring of affiliates and obtaining information necessary to assess materiality. We believe this process works most effectively when management, audit committees, and audit firms work together to evaluate the auditor's compliance with the independence rules. For example, auditors and their audit clients may need to work together to identify and monitor potential affiliates based on the affiliate of the audit client definition in the independence rules. In this regard, it will be important for management to notify the auditor in a timely manner of changes in circumstances that may affect the population of potential affiliates, such as by notifying an auditor of acquisitions before the acquisitions are effective. Additionally, management should consider communicating to auditors as early as possible the intent of private companies to file a registration statement in order for the SEC and PCAOB independence rules to be considered in advance. Issuers and their audit committees may want to consider having their own policies and procedures to identify, consider, and monitor the provision of services by and relationships with the issuer's independent accountant, which may help supplement the audit firm's system of quality control.

The following are intended as illustrative examples only, and practitioners and audit clients should be aware that an assessment of materiality requires consideration of all relevant facts and circumstances, including quantitative and qualitative factors.

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<sup>61</sup> For an overview of the obligations of auditors and audit clients with respect to auditor independence under the federal securities laws, please *see* footnote 101 of the Loan Provision Adopting Release.

### Example 1 – Assessing Materiality of Sister Entities



In this example, Company A, the entity under audit, has five controlling entities, Entities 1 through 5, with Entity 5 as the ultimate parent. Since each of Entities 1 through 5 controls Company A, directly or indirectly, each of the entities is an affiliate of Company A regardless of materiality. For purposes of this example, assume that Company A is material to Entity 1 and Entity 2 and that Company A is not material to Entity 3, Entity 4, or Entity 5. Each of Entities 1 through 5 controls other entities (*i.e.*, sister entities) other than those listed in this example. In this example, the auditor must evaluate the materiality of the sister entities controlled by each of Entity 1 and Entity 2 to determine which sister entities are affiliates of the audit client. For a sister entity controlled by Entity 1, the auditor must assess the materiality of such sister entity to

Entity 1. For a sister entity controlled by Entity 2, the auditor must assess the materiality of that sister entity to Entity 2.

### **Example 2 – Controlling and Sister Entities and Monitoring Expectations**

Assume the same facts as in Example 1. Company A and the controlling entities should provide the auditor with sufficient information to enable the auditor to appropriately monitor controlling entities and identify sister entities, even at the levels of Entities 3 through 5. We acknowledge the concerns raised by commenters that identifying sister entities that are not considered affiliates under the final amendments and re-assessing the materiality of the entity under audit and its sister entities may increase existing compliance burdens. However, identifying sister entities will be important for complying with the amended rules because there can be qualitative and quantitative changes that affect the materiality of such relationships, and audit firms will need to timely address when a sister entity becomes an affiliate. Such information also will be necessary for an audit firm to appropriately consider and apply Rule 2-01(b) on an ongoing basis.

After the initial materiality assessment is performed to identify potential affiliates, the auditor, with the assistance of and information provided by the audit client, should perform updated assessments based on, among other things, transactions, Commission filings, or other information that becomes known to the auditor and the audit client through reasonable inquiry. As a result, obtaining accurate organizational and financial information will be important to the auditor's and the audit client's ability to anticipate and plan for potential changes in materiality status that may lead to the identification of new affiliates at any point during the audit and professional engagement period. We understand that this likely will require additional compliance efforts and believe such efforts and the resultant costs are appropriate to ensure that



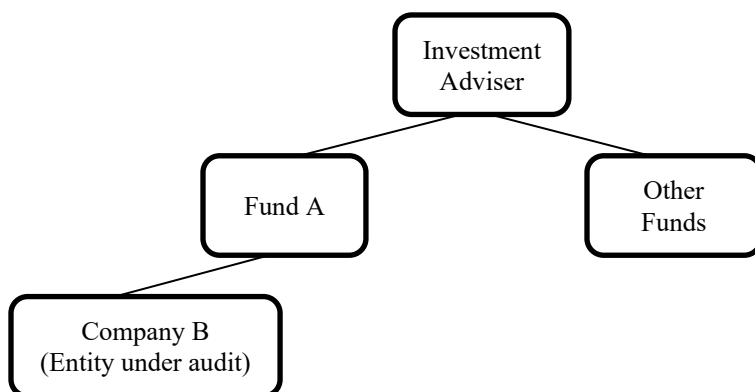
an auditor is independent from its audit client for purposes of investor protection and investor confidence. To the extent the final amendments mitigate the compliance challenges associated with independence violations or prohibitions, or allow an auditor to expand its audit or non-audit services or relationships, we expect that the auditor will weigh any related benefits against any additional monitoring and compliance costs. Also, auditors may already be familiar with the monitoring efforts related to a dual materiality threshold, as the AICPA and IESBA have analogous provisions. Where an auditor is unable to obtain the information needed to make reasonable determinations of affiliate status for sister entities, the auditor should treat such sister entities as affiliates of the audit client for the purpose of the Commission's independence requirements to avoid potentially impairing the auditor's objectivity and impartiality.

The final amendments do not include a transition framework, as requested by a commenter, to address changes in the materiality of the entity under audit or a sister entity to a controlling entity. As noted, above, we expect auditors and their clients to be able to anticipate and plan for changes in materiality and believe this approach fosters an auditor's objectivity and impartiality. To the extent that changes in materiality of the entity under audit or sister entities result in an independence violation, we encourage registrants and accountants to consult with the Commission's Office of the Chief Accountant.<sup>62</sup>

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<sup>62</sup> See Section II.E.3 and amended introductory paragraph to Rule 2-01.

### Example 3 – Identifying Affiliates of an Entity under Audit that is a Portfolio Company



Company B is the entity under audit and a portfolio company controlled by Fund A.

Fund A is an investment company within an ICC. Company B’s auditor will identify affiliates of the audit client by applying amended Rules 2-01(f)(4)(i) through (iv). While there are entities described in the ICC definition that are part of Company B’s organizational structure, including Fund A and its investment adviser or sponsor, Company B’s auditor, assuming it does not audit any entity described in the ICC definition, such as Fund A or the Investment Adviser, will not apply the ICC definition. Company B’s auditor must apply amended Rules 2-01(f)(4)(i) through (iv) to identify affiliates, which may result in certain investment companies and investment advisers or sponsors being deemed an affiliate of the audit client.

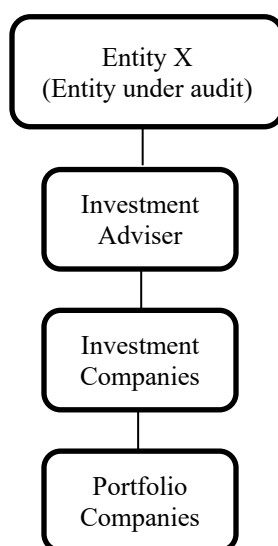
As noted above, we received a few comments related to the term “controlling entity” and the term “control,”<sup>63</sup> which is defined in Rule 1-02(g). We are not amending Rule 1-02(g) to link the definition of “control” to the accounting literature as one commenter suggested. We believe the suggestion to define “controlling entity” solely as the overall private equity firm when assessing materiality of entities, including a portfolio company, in a private equity

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<sup>63</sup> See *supra* note 54.

structure<sup>64</sup> could raise issues beyond the scope of the proposal that warrant further consideration. We are therefore not adopting this approach. Under Rule 1-02(g), whether the entity under audit is a subsidiary of an operating or holding company or a portfolio company within a private equity structure, all entities that are identified to have control over an entity under audit are controlling entities.

**Example 4 – Application of the Affiliate of the Audit Client Definition When the Entity under Audit Controls Entities within an ICC**



Entity X is the entity under audit and is not an investment company, an investment adviser, or sponsor. Entity X has a subsidiary that serves as an investment adviser to several investment companies. If the auditor is not engaged to audit the investment company or investment adviser or sponsor on a standalone basis, the auditor will apply amended Rules 2-01(f)(4)(i) through (iv) to determine the affiliates of the audit client.

We note that in determining the affiliates of Entity X, in the context of amended Rules 2-01(f)(4)(i) through (iv), it will be important to consider the relationships between the investment

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<sup>64</sup> *Id.*

adviser and the investment companies it advises. Even where an investment company has an independent board that oversees the investment company's operations and approves the advisory contract, the services provided by the investment adviser are generally critical to the management of day-to-day operations and execution of policies for the investment company. Therefore, the investment adviser generally will have a controlling relationship over the investment company for purposes of Rule 1-02(g).

In this example, if the auditor audited Entity X and the investment adviser subsidiary on a standalone basis, then the auditor would have to apply both amended Rules 2-01(f)(4)(i) through (iv) as they relate to the audit of Entity X and amended Rule 2-01(f)(14) as it relates to the audit of the investment adviser.<sup>65</sup>

#### **b. Proposing Release's Discussion of Rule 2-01(b)**

As noted in the 2000 Adopting Release, “[c]ircumstances that are not specifically set forth in our rule are measured by the general standard set forth in Rule 2-01(b).” The general standard includes, in part, that 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.”

The Commission explained in the Proposing Release that relationships and services affected by the proposed amendments to the affiliate of the audit client definition remain subject to the general independence standard in Rule 2-01(b).<sup>66</sup> The Commission also noted that such

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<sup>65</sup> This is consistent with the discussion and example included in Section II.A.1.b.i of the Proposing Release.

<sup>66</sup> See Section II.A.1 of the Proposing Release.

relationships and services, individually or in the aggregate, could raise independence concerns pursuant to the general standard in Rule 2-01(b) due to the nature, extent, relative importance or other aspects of the service or relationship that may make the service or relationship a threat to an auditor's objectivity and impartiality. The Commission indicated that such services or relationships should be "easily known" due to the nature, extent, relative importance or other aspects of the services or relationships. Although the Commission did not propose amendments to Rule 2-01(b), a number of commenters provided feedback on the application of the general independence standard in light of the proposed amendments.

**i. Comments on the Proposing Release's Discussion of Rule 2-01(b)**

Several commenters agreed that relationships and services with entities that would no longer be deemed affiliates should still be evaluated under Rule 2-01(b).<sup>67</sup> However, one commenter recommended that the Commission consider whether Rule 2-01(b) is sufficient, or whether further clarification or rulemaking might be appropriate to address situations where relationships or non-attest services provided to a sister entity that is no longer an affiliate under the proposed definitions are of a magnitude that "eclipse" the attest services provided within a private equity or investment company complex.<sup>68</sup>

A few commenters raised concerns with the Proposing Release's discussion of Rule 2-01(b).<sup>69</sup> One commenter asserted that the statements were inconsistent with the 2000 Adopting

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<sup>67</sup> See e.g., letters from Deloitte, EY, KPMG, GT, and Crowe. Some commenters also indicated that the general standard in Rule 2-01(b) is sufficient to mitigate the risks when relationships and services, individually or in the aggregate, with sister entities that are no longer deemed affiliates under the final amendments could impact an auditor's objectivity and impartiality. See e.g., letters from Deloitte, EY, and KPMG.

<sup>68</sup> See letter from BDO.

<sup>69</sup> See e.g., letters from RSM and PwC.

Release, which stated that “[c]ircumstances that are not specifically set forth in our rule are measured by the general standard set forth in Rule 2-01(b)”<sup>70</sup> and expressed concern that the Proposing Release’s discussion of Rule 2-01(b) could be applied more broadly than just to the entities captured by the affiliate of the audit client definition. Another commenter asserted that it “may be understood in practice as a change in application and operation of Rule 2-01(b).”<sup>71</sup> In voicing their concerns, these commenters noted that the consideration of Rule 2-01(b) would reduce the benefits expected to result from the proposed amendments as the auditor would continue to have to track relationships and services that are being provided to entities that are no longer affiliates.<sup>72</sup>

One commenter disagreed with the Proposing Release’s reference to “easily known” when describing the types of services or relationships that should be evaluated under Rule 2-01(b) as 17 CFR 210.2-01(c) (“Rule 2-01(c)”) no longer specifically addresses such items.<sup>73</sup> A few commenters asserted that the Proposing Release’s use of “easily known” appears to establish an expectation of continued monitoring that may reduce the benefits, efficiencies, and cost savings expected to result from the proposed amendments.<sup>74</sup> Two of these commenters requested further guidance on on-going monitoring obligations if Rule 2-01(b) continues to apply to non-affiliates and requested the Commission consider clarifying the reference to “easily

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<sup>70</sup> See letter from RSM (citing to the 2000 Adopting Release at 65 FR 76030). See *infra* discussion in Section II.A.1.b.ii.

<sup>71</sup> See letter from PwC.

<sup>72</sup> See *e.g.*, letters from RSM and PwC.

<sup>73</sup> See letter from RSM.

<sup>74</sup> See *e.g.*, letters from PwC, RSM, and AIC.

known” in the Proposing Release’s discussion of the general standard by utilizing the “knows or has reason to believe” approach of the AICPA ethics and independence rules.<sup>75</sup>

## **ii. Application of Rule 2-01(b) to the Final Amendments**

After considering the public comments and recommendations received, we affirm our view that Rule 2-01(b) applies to those relationships and services that previously were, but are no longer, covered by Rule 2-01(c) as a result of the final amendments. We do not believe that this position broadens the scope of the “all relevant facts and circumstances” concept in the general standard. Nor are we persuaded that this scope should be narrowed in light of the amendments we are adopting. Otherwise, for example, an auditor could have any number or magnitude of relationships with or provide services to sister entities that are no longer deemed affiliates under the final amendments—even where, for example, the importance of such relationships or services to the auditor and the controlling entity threatens the auditor’s objectivity and impartiality.

In response to commenters who noted that “easily known” is not a defined term and requested further explanation, we are clarifying that the types of relationships and services that must be evaluated under Rule 2-01(b) are those that are known or should be known to the auditor because of the nature, extent, relative importance or other relevant aspects of the relationships or services. Consistent with our discussion in Example 2 above, auditors, with the assistance of their audit clients, are expected to have sufficient information to be able to be aware of and prepare for changes in materiality that could lead to changes in affiliate status of entities in a large corporate or ICC structure. As such, we do not expect that identifying and monitoring

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<sup>75</sup> See letters from PwC and AIC.

relationships with and services provided to non-affiliate sister entities that are known or should be known would require significant additional effort by audit firms. For example, if audit firms are performing a high volume of services for or have a number of relationships with non-affiliate sister entities, the audit firm should already know that these relationships exist.

As noted in Section II.A.1.a.iii, the final amendments will more effectively focus the independence rules and reduce the time and attention that auditors and audit committees spend avoiding or addressing compliance challenges that arise under the existing rules and should permit auditors and audit committees to use their resources more effectively to the benefit of investors. Nothing in the final amendments is intended to change the application of the general independence standard in Rule 2-01(b). As the Commission noted in the 2000 Adopting Release and in the rule text for Rule 2-01(c), paragraph (c) is a “non-exclusive” specification of circumstances. As such, while Rule 2-01(c) enumerates specific circumstances that are inconsistent with Rule 2-01(b), the general standard of Rule 2-01(b) may encompass relationships and services that are not otherwise deemed independence-impairing by Rule 2-01(c).

### **c. Amendments to the Investment Company Complex Definition**

#### **i. Proposed Amendments**

The Commission proposed to amend Rule 2-01(f)(4) to clarify that, with respect to an entity under audit that is an investment company or an investment adviser or sponsor, the auditor and the audit client should look to proposed Rule 2-01(f)(14) (*i.e.*, the ICC definition) to identify affiliates of the audit client and not to proposed Rule 2-01(f)(4).<sup>76</sup> The Commission also

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<sup>76</sup> The proposed amendment would replace the existing “and” that appears at the end of existing Rule 2-01(f)(4)(iii) with an “or” in order to direct auditors of an investment company or an investment adviser or



proposed to amend the ICC definition in Rule 2-01(f)(14) to provide additional clarity by incorporating the term “entity under audit” into Rule 2-01(f)(14) to focus the analysis from the perspective of the entity under audit and to explicitly define the term “investment company” to include unregistered funds for the purpose of the ICC definition.<sup>77</sup> In the Proposing Release, the Commission indicated that the proposed amendments were designed to more effectively focus the independence analysis on the entity under audit, including unregistered funds under audit, and align that analysis with the independence analysis required for all investment companies.

In addition to the proposed amendments to clarify certain aspects of the ICC definition, the Commission proposed to include a materiality qualifier in the common control provision of the ICC definition to align with the proposed amendments to the affiliate of the audit client definition.<sup>78</sup> To further align with the affiliate of the audit client definition, the Commission proposed including a significant influence provision in the ICC definition.<sup>79</sup> Both of these proposed amendments were meant to provide consistency between the definitions of affiliate of the audit client and ICC in light of the proposed amendment specifying that auditors of an

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sponsor to the ICC definition. In the final amendments, the “or” now appears at the end of amended Rule 2-01(f)(4)(iv) and before amended 17 CFR 210.2-01(f)(4)(v).

<sup>77</sup> We use the term “unregistered fund” in this release to refer to entities that are not considered investment companies pursuant to the exclusions in Section 3(c) of the Investment Company Act of 1940 [15 USC 80a-3(c)].

<sup>78</sup> See Proposed Rule 2-01(f)(14)(i)(D)(I).

<sup>79</sup> See Proposed Rule 2-01(f)(14)(i)(E). The existing definition of “audit client” in Rule 2-01(f)(6), for the purpose of Rule 2-01(c)(1)(i), excludes entities that are affiliates only by virtue of the significant influence provisions in existing Rules 2-01(f)(4)(ii) and (iii). To align the treatment of affiliates due to significant influence under proposed Rule 2-01(f)(14)(i)(E) with those in the affiliate of the audit client definition, the Commission proposed an amendment to the “audit client” definition in Rule 2-01(f)(6) to similarly exclude entities identified under proposed Rule 2-01(f)(14)(i)(E).

investment company or investment adviser or sponsor would apply proposed Rule 2-01(f)(14) to identify affiliates of such entity under audit.

The Commission explained in the Proposing Release that while it was introducing a materiality qualifier in the common control provision, it was retaining within the scope of the ICC definition any investment company that has an investment adviser or sponsor that is an affiliate of the audit client—regardless of whether such sister investment companies are material to the shared investment adviser or sponsor.<sup>80</sup>

The Commission also noted that while the proposed amendments to the ICC definition would alter the composition of entities that would be deemed affiliates of the audit client principally due to a materiality qualifier being added for sister entities, the general independence standard in Rule 2-01(b) would continue to apply.<sup>81</sup> The Commission stated its belief that the proposed amendments to the ICC definition would provide clarity and address certain compliance challenges, including challenges related to the number of related entities or the volume of acquisitions and dispositions in ICCs, and more effectively focus the ICC definition on those relationships and services that are more likely to threaten auditor objectivity and impartiality.<sup>82</sup>

## **ii. Comments Received**

### **Comments on Overall Approach to ICC Definition**

Commenters generally supported the Commission’s proposal to clarify that with respect to an entity under audit that is an investment company or an investment adviser or sponsor, the

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<sup>80</sup> See Proposed Rule 2-01(f)(14)(i)(F).

<sup>81</sup> See Section II.A.1.b of the Proposing Release.

<sup>82</sup> See Section II.A.1 of the Proposing Release.

auditor and the audit client should look solely to the ICC definition to identify affiliates of the audit client,<sup>83</sup> and no commenters specifically opposed the proposed approach.

Several commenters expressly agreed with the proposed references to “entity under audit” in Rule 2-01(f)(14),<sup>84</sup> and no commenters specifically opposed the proposed references.

Some commenters supported the Commission’s proposal to include within the meaning of the term investment company, for the purposes of the ICC definition, entities “that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act.”<sup>85</sup> For example, one commenter stated that under the current rules, “it was not clear if unregistered funds would be part of the [ICC] definition, which created uncertainty and inconsistency in practice.”<sup>86</sup> Another commenter stated that, if adopted, the inclusion of unregistered funds within the ICC definition would enable “the asset management industry holistically [to] serve the interests of investors and provide for more consistent treatment across fund businesses.”<sup>87</sup> No commenters expressly opposed this proposed amendment.

Many commenters who were supportive of the proposed amendments also requested clarification on the application of the proposed definitions to specific fact patterns, including the following circumstances:

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<sup>83</sup> See e.g., letters from NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, GT, Crowe, and ICI/IDC. One commenter recommended that the final amendments specify that the ICC definition applies when the entity obtains an audit “for SEC reporting or compliance purposes.” See letter from KPMG. We believe this concept is implied by the requirements to apply Rule 2-01 in certain applicable provisions of the Federal securities laws.

<sup>84</sup> See e.g., letters from NYSSCPA, Deloitte, BDO, EY, KPMG, and GT.

<sup>85</sup> See e.g., letters from Deloitte, EY, KPMG, Crowe, and RSM.

<sup>86</sup> See letter from Crowe.

<sup>87</sup> See letter from EY.

- An investment adviser is the entity under audit and is both an issuer and parent entity;<sup>88</sup>
- An operating company is the entity under audit and has sister entities that include an investment company or an investment adviser or sponsor,<sup>89</sup> or the operating company under audit has a subsidiary that is an investment adviser that manages investment companies;<sup>90</sup> and
- The entity under audit is an investment company with sister funds advised by the same investment adviser, and such sister funds control portfolio companies.<sup>91</sup>

Regarding other general aspects of the proposed ICC definition, one commenter sought clarification about whether the reference to investment adviser or sponsor in the proposed ICC definition also would include custodians.<sup>92</sup> A different commenter requested that we revise the ICC definition to separately address affiliates of an investment company and affiliates of an investment adviser or sponsor.<sup>93</sup>

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<sup>88</sup> See e.g., letters from CAQ and ICI/IDC. Consistent with the discussion in Section II.A.1 of the Proposing Release, where an auditor is auditing only an investment company or investment adviser or sponsor, such auditor would look to the amended ICC definition to identify affiliates of the audit client. Even where the investment adviser under audit is an issuer and a parent entity, the final amendments dictate that the adviser's auditor look solely to the amended ICC definition to identify affiliates of the audit client.

<sup>89</sup> See e.g., letters from CAQ and Deloitte. The discussion in Section II.A.1.a.iii, above, including Example 3, illustrates how to apply the amended definitions where an auditor audits only a portfolio company.

<sup>90</sup> See letter from EY. The discussion in Section II.A.1.a.iii, above, including Example 4, illustrates how to apply the amended definitions in response to this circumstance.

<sup>91</sup> See e.g., letters from CAQ, BDO, EY, KPMG, Crowe, and AIC. The discussion in Section II.A.1.c.iii, including Example 5, below, illustrates how to apply the amended definitions in response to this circumstance. One commenter raised a related fact pattern and suggested aligning the proposed amendments with the recent amendments to the Loan Provision. See letter from PwC.

<sup>92</sup> See letter from EY; see also *infra* note 118.

<sup>93</sup> See letter from RSM. We do not see a compelling reason to adopt this approach and create separate provisions for these related entities within an ICC. Additionally, such an approach may be duplicative and add unnecessary complexity to the amended ICC definition.

## Comments on Proposed Rule 2-01(f)(14)(i)(D)(I) – Common Control and Materiality

Many commenters supported the inclusion of a materiality qualifier within proposed Rule 2-01(f)(14)(i)(D)(I), the common control provision of the proposed ICC definition.<sup>94</sup> Consistent with feedback received in response to the proposed materiality qualifier for operating companies under common control,<sup>95</sup> some commenters expressed the view that the materiality qualifier would not increase the risk to auditor objectivity and impartiality.<sup>96</sup> A few commenters, consistent with their feedback on the affiliate of the audit client definition, also recommended that proposed Rule 2-01(f)(14)(i)(D)(I) include a dual materiality threshold that would include consideration of whether the entity under audit is material to the controlling entity.<sup>97</sup>

However, the two commenters that opposed the proposed materiality qualifier in the affiliate of the audit client definition also opposed, for similar reasons, the inclusion of such a qualifier in the proposed ICC amendments.<sup>98</sup>

While some commenters indicated that auditors would not experience significant challenges or burdens with assessing materiality in the ICC context,<sup>99</sup> other commenters voiced concerns or noted that additional guidance about the application of materiality would be helpful.<sup>100</sup> Some commenters noted the importance of access to current financial information of

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<sup>94</sup> See e.g., letters from CAQ, BDO, EY, KPMG, RSM, PwC, GT, Crowe, AIC, ICI/IDC, IBC, CCMC, and Charles E. Andrews, Audit Committee Chair, Washington Mutual Investors Fund, *et al* (Mar. 10, 2020) (“Fund AC Chairs”).

<sup>95</sup> See Section II.A.1.a.iii.

<sup>96</sup> See e.g., letters from EY, RSM, and KPMG.

<sup>97</sup> See e.g., letters from EY, AIC, and CCMC.

<sup>98</sup> See letters from CII and CFA.

<sup>99</sup> See e.g., letters from Fund AC Chairs, EY, and RSM.

<sup>100</sup> See e.g., letters from NYSSCPA, GT, RSM, KPMG, PwC and ICI/IDC.

controlling entities and sister entities for auditors and their clients if the proposed amendments were adopted.<sup>101</sup> In this regard, some commenters requested that the Commission address the shared responsibility of auditors, their audit clients, and audit committees.<sup>102</sup>

In response to a request for comment regarding potential application challenges in the Proposing Release, one commenter indicated there may be challenges in applying the materiality qualifier because the current definition does not require an assessment of materiality of sister entities in the context of the ICC.<sup>103</sup> The commenter suggested that such challenges could be addressed by auditors, the Commission, and companies working together to develop consistent practices and protocols for providing the information needed by auditors to maintain compliance with the independence rules. Similarly, another commenter requested guidance on the timing and frequency of monitoring materiality in the ICC context. The commenter suggested the Commission clarify that, if the sister investment adviser or a fund advised by such sister investment adviser were not deemed material to the controlling entity after an initial assessment, then the auditor could satisfy its obligation to monitor materiality on an ongoing basis in response to significant transactions, SEC filings, or other information that becomes known to the auditor, or the audit client, through reasonable inquiry.<sup>104</sup>

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<sup>101</sup> See e.g., letters from RSM, GT, KPMG, PwC, ICI/IDC, and Fund AC Chairs.

<sup>102</sup> See e.g., letters from PwC and EY.

<sup>103</sup> See letter from KPMG.

<sup>104</sup> See letter from ICI/IDC. See also letters from Deloitte (expressing a similar view as it relates to both Rule 2-01(f)(4) and Rule 2-01(f)(14)) and PwC (suggesting a transition framework to address inadvertent independence violations that arise out of an unexpected change in the population of affiliates for reasons other than a merger or acquisition).

Under the proposal, auditors and audit clients would have to assess the materiality of sister entities to their controlling entity even if the sister entities' investment advisers are not material to the entity that controls both the sister entities and the entity under audit. In response to a request for comment regarding whether auditors should have to assess the materiality of sister investment companies to a controlling entity even where the investment advisers for such sister investment companies are not material to a controlling entity, commenters generally thought requiring such assessment would be appropriate to account for instances when a controlling entity may have an investment in an investment company that would make the investment company material to the controlling entity even though the investment company's adviser is not material to the same controlling entity.<sup>105</sup>

**Comments on Proposed Rule 2-01(f)(14)(i)(F) – Inclusion of Investment Companies Advised or Sponsored by an Affiliate Investment Adviser or Sponsor**

In the Proposing Release, the Commission requested comment regarding whether proposed Rule 2-01(f)(14)(i)(F), which would include within an ICC any investment company that has any investment adviser or sponsor that is an affiliate of the audit client pursuant to proposed Rules 2-01(f)(14)(i)(A) through (D), should be adopted. Several commenters supported the continued inclusion of sister investment companies under proposed Rule 2-01(f)(14)(i)(F), regardless of the materiality of the sister investment companies once an investment adviser is deemed to be an affiliate under Rules 2-01(f)(14)(i)(A) through (f)(14)(i)(D).<sup>106</sup> However, one commenter stated that not including a materiality qualifier in

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<sup>105</sup> See e.g., letters from EY, KPMG, and RSM. One commenter noted that this situation is “not likely to be common.” See letter from EY. Another commenter requested additional guidance to foster consistent application. See letter from KPMG.

<sup>106</sup> See e.g., letters from BDO, EY, KPMG, and ICI/IDC.

proposed Rule 2-01(f)(14)(i)(F) renders the relief intended by the common control provision in the proposed ICC definition “inconsequential.”<sup>107</sup> Another commenter, while supportive of proposed Rule 2-01(f)(14)(i)(F), recommended that the reference to proposed Rule 2-01(f)(14)(i)(D) be removed from proposed Rule 2-01(f)(14)(i)(F) with respect to investment companies advised by sister investment advisers, because the proposed provision appeared to be inconsistent with other proposed provisions that would include a materiality qualifier for sister entity affiliates.<sup>108</sup>

### **Comments on Proposed Rule 2-01(f)(14)(i)(E)—the Significant Influence Provision**

Some commenters expressly supported the proposed amendment to introduce a significant influence provision in proposed Rule 2-01(f)(14)(i)(E),<sup>109</sup> and no commenters specifically opposed the proposed amendment. One commenter, while not explicitly supporting or objecting, recommended that the Commission reiterate the statement from the Loan Provision Adopting Release that provides guidance on how to apply significant influence in an investment company context.<sup>110</sup>

Commenters that addressed this aspect of the proposal also supported the proposed conforming amendment to Rule 2-01(f)(6) to reference the proposed significant influence provision in the ICC definition.<sup>111</sup>

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<sup>107</sup> See letter from RSM. Specifically, the commenter stated that all entities with a common investment adviser or sponsor should not automatically be deemed affiliates when other common control entities that are not material to the controlling entity are not deemed affiliates.

<sup>108</sup> See letter from KPMG.

<sup>109</sup> See e.g., letters from CAQ, BDO, EY, KPMG, and RSM.

<sup>110</sup> See letter from ICI/IDC.

<sup>111</sup> See e.g., letters from EY, KPMG, and RSM.



### iii. Final Amendments

#### Overall Approach to ICC Definition

After considering the public comments and recommendations received, we are adopting, substantially as proposed, amendments to the ICC definition in amended 17 CFR 210.2-01(f)(14) (“amended Rule 2-01(f)(14)”), with modifications to address the concerns and suggestions raised by commenters and to align the ICC definition with the final amendment related to the dual materiality threshold in amended Rule 2-01(f)(4)(ii) discussed above.<sup>112</sup>

Consistent with the proposal, the final amendments to Rule 2-01(f)(4), the affiliate of the audit client definition, direct an auditor of an investment company or investment adviser or sponsor to apply the ICC definition in amended Rule 2-01(f)(14) to identify affiliates. As proposed, the amended ICC definition uses the term “entity under audit” as the starting point for the analysis of entities included within the ICC definition.<sup>113</sup> We also are adopting as proposed a definition of “investment company” for the purpose of amended Rule 2-01(f)(14) that includes unregistered funds.<sup>114</sup>

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<sup>112</sup> See Section II.A.1.a.iii.

<sup>113</sup> In addition, the final amendments make conforming technical amendments to amended 17 CFR 210.2-01(f)(14)(i) to incorporate the term “entity under audit.” Using the term “entity under audit” in those subparagraphs alleviates the need to refer to each subparagraph separately, which makes the subparagraphs more concise. The conforming amendments to the subparagraphs of amended 17 CFR 210.2-01(f)(14)(i) retain the application of the ICC definition as described in the Proposing Release.

<sup>114</sup> One commenter suggested that the Commission clarify whether commodity pools are included within the meaning of the term investment company for the purpose of applying amended Rule 2-01(f)(14). See letter from PwC. The term investment company, for the purpose of amended Rule 2-01(f)(14), does not include a commodity pool unless that commodity pool is an investment company or would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940.

Similarly, the final amendments to the ICC definition include the significant influence provision of new 17 CFR 210.2-01(f)(14)(i)(E) (“Rule 2-01(f)(14)(i)(E)”) substantially as proposed but modified to incorporate the term “entity under audit.”

**New 17 CFR 210.2-01(f)(14)(i)(D) – Common Control and Materiality**

After considering the public comments and recommendations received, we are adopting, with modification, new 17 CFR 210.2-01(f)(14)(i)(D) (“Rule 2-01(f)(14)(i)(D)”) to incorporate the dual materiality threshold in the common control provision, consistent with the modification to the common control provision we are adopting for the affiliate of the audit client definition.<sup>115</sup>

We were persuaded by commenters that the dual materiality threshold for identifying common control affiliates will be equally helpful in reducing compliance challenges in the ICC context as in the operating company context.<sup>116</sup> Such alignment also provides internal consistency within Rule 2-01, which should facilitate compliance efforts by reducing the potential for confusion and inconsistency when assessing common control affiliates.

Although some commenters objected to including a materiality threshold in the ICC amendments, we do not believe the adopted approach increases the risk to auditor independence. When an entity under audit is under common control with an investment company, or an investment adviser or sponsor, and the adopted dual materiality threshold is not met, we believe there is less risk to an auditor’s objectivity and impartiality from the auditor’s services to or relationships with such sister entity, for the reasons discussed regarding the dual materiality

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<sup>115</sup> See Section II.A.1.a.iii.

<sup>116</sup> See e.g., letters from EY, AIC, and CCMC. For example, CCMC expressed the view that Rule 2-01(f)(14)(i)(D) should 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 or sponsor of an investment company under audit, are material to the controlling entity.

threshold for the common control provision in the affiliate of the audit client definition.<sup>117</sup>

Further, we believe any threats to independence that may exist when the entity under audit is not material to the controlling entity will be sufficiently mitigated by the general independence standard in Rule 2-01(b).<sup>118</sup>

In response to commenters' request for guidance, consistent with the discussion in Section II.A.1.a.iii above, we remind auditors and their audit clients of their shared responsibility to monitor independence, including monitoring affiliates and obtaining information necessary to assess materiality. We are not providing any specific guidance on materiality at this time because we understand that auditors and their audit clients have developed approaches to determine materiality in compliance with current rules, and we expect those approaches would continue to be applicable under the final amendments. Auditors, working together with their audit clients, should assess materiality for the purpose of complying with Rule 2-01, as amended, including consideration of relevant qualitative and quantitative factors. Depending on the circumstances, it may be reasonable to use certain measures, such as assets under management,

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<sup>117</sup> Rule 2-01(f)(14)(i)(D) retains the existing provision that includes sister entities engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any entity identified by amended 17 CFR 210.2-01(f)(14)(i)(A) (“amended Rule 2-01(f)(14)(i)(A)”) and amended 17 CFR 210.2-01(f)(14)(i)(B), regardless of materiality.

<sup>118</sup> One commenter sought clarification about whether Rule 2-01(f)(14) would apply to engagements required by Rule 206(4)-2(a)(6) under the Investment Advisers Act of 1940 (the “Advisers Act Custody Rule”). See letter from EY; 17 CFR 275.206(4)-2(a)(6). The Advisers Act Custody Rule requires that when an investment adviser or a related person acts as a qualified custodian for client funds and securities, the investment adviser, in addition to the independent verification requirement, must annually obtain, or receive from the related person, an internal control report prepared by an independent public accountant. The Advisers Act Custody Rule defines a “related person” as “any person, directly or indirectly, controlling or controlled by [the investment adviser], and any person that is under common control with [the investment adviser].” 17 CFR 275.206(4)-2(d)(7). For purposes of this engagement, the related person qualified custodian would be the “entity under audit” under the final rule. Accordingly, the auditor engaged would apply amended Rule 2-01(f)(4)—not amended Rule 2-01(f)(14)—to determine the affiliates of the audit client, which would require the auditor to assess the investment adviser’s materiality if under common control. In these circumstances, however, the accountant would be required to be independent of the adviser under Rule 2-01(b) regardless of the results of this materiality determination.

when evaluating a potential affiliate in one instance, but not when evaluating a different potential affiliate. The assessment also should be attentive to the nature of the relationship, the governance structure of the entity, certain business and financial relationships, and other relevant qualitative considerations.

As noted in Section II.A.1.a.iii, understanding the organizational structure of an audit client is important when considering the general standard under Rule 2-01(b). We believe that after the initial materiality assessment to identify potential affiliates, the auditor and the audit client should conduct updated assessments based on any transactions, Commission filings, or other information that become known to the auditor or the audit client through reasonable inquiry.

**New 17 CFR 210.2-01(f)(14)(i)(F) – The Provision to Include Investment Companies Advised or Sponsored by an Affiliate Investment Adviser or Sponsor**

After considering the public comments and recommendations received, we are adopting, as proposed, new 17 CFR 210.2-01(f)(14)(i)(F) (“Rule 2-01(f)(14)(i)(F)”), which includes certain sister investment companies within the ICC definition regardless of materiality. We believe that this paragraph, together with the amendments to the common control provision in Rule 2-01(f)(14)(i)(D), as discussed above, will focus the scope of our independence rules on entities where relationships and services are more likely to threaten an auditor’s objectivity and impartiality.

Specifically, under the existing ICC definition, sister investment advisers or sponsors and, as a result, their funds, regardless of whether the sister investment advisers or sponsors are material to the applicable controlling entities, would be included in the ICC of an investment

company under audit.<sup>119</sup> Rule 2-01(f)(14)(i)(F) includes within the ICC definition investment advisers or sponsors identified by amended Rules 2-01(f)(14)(i)(A) through (D), which will include sister investment advisers or sponsors where a dual material relationship exists pursuant to Rule 2-01(f)(14)(i)(D) and exclude sister investment advisers or sponsors where a dual material relationship does not exist. While some commenters indicated that Rule 2-01(f)(14)(i)(F) should include a materiality qualifier, we believe that such an approach risks excluding entities where an auditor's services to or relationships with a sister investment company could impair an auditor's objectivity and impartiality because the sister investment company is advised or sponsored by an affiliate investment adviser or sponsor.

Where a sister investment company shares the same adviser or sponsor as an investment company under audit, we continue to believe that these entities should be included as part of the ICC in evaluating the auditor's independence, regardless of whether such sister investment company is material to the shared investment adviser or sponsor. In our view, the nature of the relationship between the investment adviser and the entity under audit that it advises presents risks to an auditor's objectivity and impartiality when the auditor has relationships with or provides services to investment companies advised by such investment adviser.

Similarly, when a sister investment adviser or sponsor is included under the dual materiality threshold, we believe that the investment companies advised or sponsored by the sister investment adviser or sponsor should be included as part of the ICC in evaluating the auditor's independence, regardless of whether such sister investment companies are material to the applicable controlling entities. Once the sister investment adviser or sponsor is included in the ICC due to the dual materiality threshold, relationships with and services to investment

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<sup>119</sup> See Rule 2-01(f)(14).

companies advised or sponsored by the sister investment adviser or sponsor also are more likely to pose a threat to an auditor’s objectivity and impartiality.

**Amended 17 CFR 210.2-01(f)(14)(i)(C) – Application to Portfolio Companies Controlled by Sister Investment Companies**

As noted above, we received several comments regarding how the control provision in proposed Rule 2-01(f)(14)(i)(C) applies to portfolio companies of an affiliate sister investment company when an investment company is under audit.<sup>120</sup> We are mindful of the concerns raised by commenters and are adopting the control provision in amended 17 CFR 210.2-01(f)(14)(i)(C) (“amended Rule 2-01(f)(14)(i)(C)”) with modifications to apply a dual materiality threshold for portfolio companies of sister investment companies that are controlled by the investment adviser or sponsor unless the portfolio companies are engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to any entity identified by amended Rules 2-01(f)(14)(i)(A) or (B). As illustrated by Example 5 below, this modification will affect only the application of the rule for portfolio companies because Rule 2-01(f)(14)(i)(F), as discussed above, will dictate when sister investment companies are included within the ICC definition.

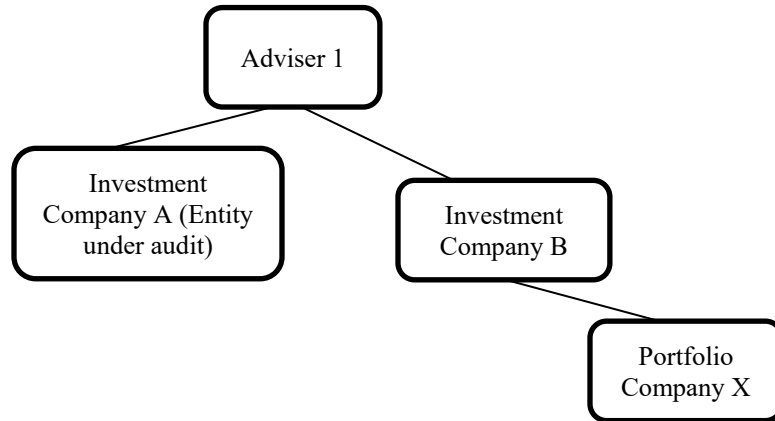
Under a scenario where neither the investment company under audit nor the portfolio company is material to the shared investment adviser or sponsor, there is less risk to the auditor’s objectivity and impartiality. The modification in amended Rule 2-01(f)(14)(i)(C) does not alter the application of the ICC definition to portfolio companies controlled by an investment company under audit, as such portfolio companies will always be included in the ICC pursuant to amended 17 CFR 210.2-01(f)(14)(i)(C)(I) (“amended Rule 2-01(f)(14)(i)(C)(I)”). The

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<sup>120</sup> See e.g., letters from CAQ, BDO, EY, KPMG, Crowe, and AIC.

following is intended as an illustrative example only, and practitioners and audit clients should be aware that an assessment of materiality requires consideration of all relevant facts and circumstances, including quantitative and qualitative factors.

**Example 5 – Application of New 17 CFR 210.2-01(f)(14)(i)(C)(2)**



Investment Company A, the entity under audit, is advised by Adviser 1, which also advises Investment Company B. Investment Company B controls Portfolio Company X and, as a result, Adviser 1 is deemed to control Portfolio Company X. Pursuant to amended Rule 2-01(f)(14)(i)(C)(1), Investment Company A’s auditor would include in the ICC any portfolio company controlled by Investment Company A even if the portfolio company is not material to Adviser 1. Pursuant to Rule 2-01(f)(14)(i)(F), the auditor also would include in the ICC Investment Company B even if Investment Company B is not material to Adviser 1. However, the auditor would apply the dual materiality threshold in new 17 CFR 210.2-01(f)(14)(i)(C)(2) (“Rule 2-01(f)(14)(i)(C)(2)”) to determine if Portfolio Company X is included in the ICC in connection with Investment Company A’s audit. If neither Portfolio Company X nor Investment Company A is material to Adviser 1 and Portfolio Company X is not engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to any entity

identified by amended Rules 2-01(f)(14)(i)(A) and (B), Portfolio Company X would not be included in the ICC in connection with the audit of Investment Company A.

## **2. Amendment to the Definition of Audit and Professional Engagement Period**

Rules 2-01(c)(1) through (5) prescribe certain circumstances the occurrence of which during the “audit and professional engagement period” are inconsistent with the general standard under Rule 2-01(b).<sup>121</sup> Under the current rule, the term “audit and professional engagement period” is defined differently for domestic issuers and foreign private issuers (“FPIs”)<sup>122</sup> that are filing, or required to file, a registration statement or report with the Commission for the first time (“first-time filers”). Specifically, 17 CFR 210.2-01(f)(5)(i) and (ii) define the audit and professional engagement period as including both the “period covered by any financial statements being audited or reviewed” and the “period of the engagement to audit or review the . . . financial statements or to prepare a report filed with the Commission . . .” (the “look-back period”). However, 17 CFR 210.2-01(f)(5)(iii) (“Rule 2-01(f)(5)(iii)”) of the definition narrows the audit and professional engagement period for audits of the financial statements of foreign private issuers to the “first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.”

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<sup>121</sup> See Preliminary Note 2 and Rules 2-01(c)(1) through (5).

<sup>122</sup> 17 CFR 240.3b-4(c). A foreign private issuer is any foreign issuer other than a foreign government, except for an issuer that (1) has more than 50% of its outstanding voting securities held of record by U.S. residents; and (2) any of the following: (i) a majority of its executive officers or directors are citizens or residents of the United States; (ii) more than 50% of its assets are located in the United States; or (iii) its business is principally administered in the United States. See 17 CFR 240.3b-4(c).



### **a. Proposed Amendments**

The Commission proposed to amend Rule 2-01(f)(5)(iii) so that the one year look-back period for first-time filers will apply to all such filers, which would result in treating all first-time filers (*i.e.*, domestic issuers and FPIs) similarly for purposes of the independence requirements under Rule 2-01.<sup>123</sup>

In the Proposing Release, the Commission explained that the proposed amendment would provide parity between domestic issuers and FPIs and noted feedback that such parity may also benefit capital formation.<sup>124</sup> The Commission stated its belief that the proposed requirement to comply with applicable independence standards in all prior periods included in the first-time filing sufficiently mitigates the risk associated with shortening the look-back provision for domestic first-time filers. In addition, as it relates to relationships and services in prior years that would not be included in the look-back period as a result of the proposed amendment, the Commission noted that such relationships and services still would be considered under the general independence standard of Rule 2-01(b), either individually or in the aggregate.

### **b. Comments Received**

Many commenters supported the proposed amendment to shorten the domestic company look-back period for evaluating independence compliance to the most recent year to be included in the first filing with the Commission.<sup>125</sup> Several commenters stated that the current

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<sup>123</sup> The proposed amendment would not impact the compliance analysis related to the partner rotation provisions in 17 CFR 210.2-01(c)(6).

<sup>124</sup> See Section II.A.2 of the Proposing Release.

<sup>125</sup> See *e.g.*, letters from NASBA, CAQ, AICPA, Deloitte, BDO, EY, KPMG, RSM, PwC, Crowe, AIC, EQT, FEI, GT, CCMC, and Parrett.

requirement can result in challenges, cost, or delays to an initial public offering (“IPO”).<sup>126</sup> One commenter indicated that these challenges are especially relevant in the private equity environment where strategies change within a one- or two-year time frame.<sup>127</sup> Some commenters also noted that the current provision puts domestic issuers at a disadvantage relative to FPIs.<sup>128</sup>

Some commenters opposed the proposed amendment and, instead, suggested the Commission lengthen the look-back period for FPIs.<sup>129</sup> One of these commenters posited that entities contemplate going public for years before an IPO and, as such, the current domestic look-back period is not an “egregious” burden.<sup>130</sup> Another commenter cited the increased risk associated with “unicorn” IPOs and asserted that this proposed amendment would weaken the applicable independence rules when serious questions “have arisen around accounting practices at some of the largest private companies.”<sup>131</sup>

A few commenters supported the Commission’s view that all relationships and services in prior periods should still be evaluated under Rule 2-01(b) and that these relationships and services should be easily known.<sup>132</sup>

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<sup>126</sup> See e.g., letters from CAQ, Deloitte, EY, EQT, GT, PwC, and AIC.

<sup>127</sup> See letter from BDO.

<sup>128</sup> See e.g., letters from EQT and FEI.

<sup>129</sup> See e.g., letters from NYSSCPA, CII, and CFA.

<sup>130</sup> See letter from NYSSCPA.

<sup>131</sup> See letter from CFA.

<sup>132</sup> See e.g., letters from Deloitte and KPMG. *But see* letters from RSM and PwC. The view expressed by RSM and PwC regarding the application of Rule 2-01(b) also applies to the discussion of its applicability in this context.

Several commenters also requested that the Commission clarify how the proposed amendment would apply to specific situations such as:

- Reverse mergers or special purpose acquisition companies, if such a transaction is being considered by an audit client that is currently an issuer;<sup>133</sup>
- An existing and a new audit relationship;<sup>134</sup> and
- When a registration statement is withdrawn and a new registration statement subsequently is filed.<sup>135</sup>

### **c. Final Amendments**

After considering the public comments and recommendations received, we are adopting amended 17 CFR 210.2-01(f)(5)(iii) (“amended Rule 2-01(f)(5)(iii)”) as proposed. As noted in the Proposing Release, the staff has observed, from its independence consultation experience related to potential filings of initial registration statements, that often one factor, among many, in the auditor’s objectivity and impartiality analysis is how long ago the service or relationship ended. If the service or relationship ended in the early years of the financial statements included in the initial registration statement, that fact may support a conclusion that the auditor is objective and impartial under Rule 2-01 at the time the IPO is consummated. As discussed above, a number of commenters supported the Commission’s reasoning for the proposal.

We were not persuaded by the commenters who opposed the proposal and who recommended lengthening the look-back period for FPIs instead. As a general matter, we

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<sup>133</sup> See letter from GT.

<sup>134</sup> See letter from KPMG.

<sup>135</sup> See letters from GT and Crowe.

believe that lengthening the look-back period would unnecessarily increase the burden on capital formation and impose new regulatory costs on FPIs without significantly enhancing investor protection. With respect to the comment regarding the impact of shortening the look-back period for “unicorn” IPOs,<sup>136</sup> it is not clear that financial reporting quality would be undermined or concerns, such as “inadequate corporate governance and lax accounting practices,” would be exacerbated by the shorter look-back period for domestic issuers. Moreover, the final amendments do not affect the auditing standards to which a company undergoing an IPO is subject. Additionally, we continue to believe that applying Rule 2-01 to the most recent fiscal year, together with the application of the general independence standard in Rule 2-01(b) and the requirement to comply with applicable independence standards for the earlier years, mitigate the risk to an auditor’s objectivity and impartiality associated with the shorter look-back period.<sup>137</sup>

In response to some commenters’ request for clarification or guidance, we note that the final amendment applies to both existing and new audit relationships. We see no proportionate investor protection benefit to introducing complexity to a first-time filer’s decision whether to retain or select a new auditor by applying different standards. Where a registrant is undergoing a reverse merger that is in substance similar to an IPO, the audit client and auditor should not apply the transition framework discussed in Section II.D, but may apply the shorter look-back period under the final amendments.<sup>138</sup> Finally, consistent with the position taken by the staff in

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<sup>136</sup> See letter from CFA.

<sup>137</sup> For additional guidance regarding the application of Rule 2-01(b) to the final amendments, see Section II.A.1.a.iii, above.

<sup>138</sup> See Section II.D.3.

consultations, we are clarifying that where an issuer withdraws an initial registration statement, the re-filing of a new registration statement would be considered the issuer's first-time filing.

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

### **1. Amendment to Except Student Loans**

#### **a. Proposed Amendment**

The Loan Provision in Rule 2-01(c)(1)(ii)(A) provides that an accountant is not independent if it has any loan to or from an audit client and certain other persons related to the audit client. The Loan Provision also excepts four types of loans from its scope.<sup>139</sup> The Commission proposed to add an exception to 17 CFR 210.2-01(c)(1)(ii)(A)(I) (“Rule 2-01(c)(1)(ii)(A)(I)”) for student loans obtained from a financial institution 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 firm as defined in 17 CFR 210.2-01(f)(11).<sup>140</sup>

In the Proposing Release, the Commission indicated that limiting the exception to student loans “not obtained while the covered person in the firm was a covered person” would provide a familiar compliance principle as it is consistent with the limitation to the primary mortgage loan exception in current 17 CFR 210.2-01(c)(1)(ii)(A)(I)(iv) (“Rule 2-01(c)(1)(ii)(A)(I)(iv)”). The Commission also expressed the belief that obtaining a student loan as a covered person poses a higher risk to the auditor’s objectivity and impartiality and creates, at a minimum, an

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<sup>139</sup> See Rule 2-01(c)(1)(ii)(A)(I)(i) through (iv), which lists as excepted loans those that are collateralized by automobiles, insurance policies, cash deposits, and primary residences.

<sup>140</sup> See 17 CFR 210.2-01(f)(11), defining which partners, principals, shareholders, and employees of an accounting firm are considered covered persons.

independence appearance issue that is not present when a non-covered person obtained a similar student loan from such audit client.

The proposed amendment also limited the exclusion to student loans obtained for the covered person's educational expenses. The Commission did not propose to extend the exception to a covered person's immediate family members due to concerns, at that time, that the amount of student loan borrowings could be significant when considering student loans obtained for multiple immediate family members and thus could impact an auditor's objectivity and impartiality.

#### **b. Comments Received**

Commenters generally supported adding student loans to the list of excepted loans.<sup>141</sup> Many commenters recommended that the Commission expand the exception to include student loans of the covered person's immediate family members under the same terms as the proposed amendment.<sup>142</sup> For example, one commenter questioned the Commission's argument that "the amount of student loan borrowings could be significant when considering student loans obtained for multiple immediate family members and thus could impact an auditor's objectivity and impartiality" when considering that there is no similar proscription with respect to a mortgage loan, which could be substantially more significant than student loan debt in terms of absolute dollars.<sup>143</sup> However, another commenter agreed with the proposal not to include student loans of

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<sup>141</sup> See e.g., letters from NASBA, NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, CII, ICI/IDC, IBC, FEI, Fund AC Chairs, and CCMC.

<sup>142</sup> See e.g., letters from NASBA, NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe and ICI/IDC.

<sup>143</sup> See letter from NYSSCPA.

immediate family members in the proposed amendment.<sup>144</sup>

In the Proposing Release, the Commission requested comment on whether student loans of a covered person's immediate family members also should be excluded. Some commenters indicated that even if the proposed amendment were expanded to include student loans of immediate family members, there should be no limit on the amount outstanding.<sup>145</sup> One commenter suggested that the materiality of the loan to the covered person's net worth should be considered.<sup>146</sup> A few commenters indicated that Rule 2-01(b) should mitigate the risks of the amount of student loans impairing an auditor's objectivity and impartiality.<sup>147</sup> Without addressing immediate family members' loans, some commenters asserted that there should be no limit on the amount outstanding, similar to the existing primary residence mortgage exception.<sup>148</sup> We also note that certain commenters requested that the Commission clarify the scope of the term "educational expenses" and whether it includes expenses for room and board, tuition, books, and other educational supplies.<sup>149</sup>

### **c. Final Amendment**

After considering the public comments and recommendations received, we are adopting amendments to except certain student loans from the Loan Provision with two modifications from the proposed amendments. Consistent with the recommendation of many commenters, the final amendment also will except student loans obtained by a covered person's immediate family

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<sup>144</sup> See letter from CII.

<sup>145</sup> See e.g., letters from RSM, Deloitte, and EY.

<sup>146</sup> See letter from NASBA.

<sup>147</sup> See e.g., letters from Deloitte and EY.

<sup>148</sup> See e.g., letters from NYSSCPA, BDO, and KPMG.

<sup>149</sup> See e.g., letters from CAQ, BDO, PwC, Crowe, and GT.

members, as that term is defined in 17 CFR 210.2-01(f)(13). We are persuaded that there is no need to include such a limitation, especially in light of the fact that similar exclusions, such as the one for mortgage loans, are not similarly proscribed. Also, in response to comments seeking guidance on the term “educational expenses,” we believe the entire balance for loans that qualify as a student loan under the applicable terms, conditions, and requirements should be within the scope of the final amendments.

The proposed amendment’s reference to student loans “obtained for a covered person’s or his or her immediate family members’ educational expenses” was intended to make explicit that it is only student loans for the covered persons’ and their immediate family members’ educational expenses that should be covered and not loans that they undertake to pay for another person’s educational expenses. That limitation continues to apply. However, we are modifying the rule text to delete this phrase to avoid potential confusion about whether “educational expenses” is meant as a limitation on the amount of student loans excepted.<sup>150</sup> The remaining terms of the exclusion are consistent with the proposal.

We are not specifying a numerical limit to the amount of outstanding student loans held by a covered person or a covered person’s immediate family members that would be excepted. In light of comments received, we are persuaded that the purpose for which student loans are incurred and the standard terms associated with such loans set them apart from other debtor/creditor relationships not excepted from the Loan Rule and are less likely to threaten an auditor’s objectivity and impartiality. We believe the nature of student loans and the requirement that the loans are obtained from a financial institution under its normal lending

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<sup>150</sup> With “educational expenses” deleted, the reference to covered persons and their immediate family members would be duplicative of the same references in 17 CFR 210.2-01(c)(1)(ii).



procedures, terms, and requirements mitigate the risk such loans would pose to an auditor’s objectivity and impartiality. Not including a numerical limit also is consistent with the exception for mortgage loans in Rule 2-01(c)(1)(ii)(A)(I)(iv).

## **2. Amendment to Clarify the Reference to “A Mortgage Loan”**

### **a. Proposed Amendment**

The Commission proposed a clarifying amendment to the reference to “a mortgage loan” in Rule 2-01(c)(1)(ii)(A)(I)(iv) to refer to “mortgage loans” in the plural. As noted in the Proposing Release, Rule 2-01(c)(1)(ii)(A)(I)(iv) was not intended to exclude just one outstanding mortgage loan on a borrower’s primary residence, and the Commission staff has previously provided guidance consistent with the proposed amendment.<sup>151</sup>

### **b. Comments Received**

Commenters supported the proposed amendment.<sup>152</sup> We received no comments specifically opposing this proposed amendment. One commenter requested examples of how the proposed amendment applies to different types of mortgage loans, such as home equity or home improvement loans.<sup>153</sup> Another commenter suggested that the Commission consider extending the exemption to include mortgages collateralized by property other than primary residences.<sup>154</sup>

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<sup>151</sup> See Section B. Question 1 Office of the Chief Accountant: Application of the Commission’s Rules on Auditor Independence Frequently Asked Questions (June 27, 2019) (originally issued August 6, 2007) (“Auditor Independence FAQs”) (indicating the staff’s view that the rationale for a mortgage on a primary residence also applies to second mortgages, home improvement loans, equity lines of credit and similar mortgage obligations collateralized by a primary residence obtained from a financial institution under its normal lending procedures, terms and requirements and while not a covered person in the firm).

<sup>152</sup> See e.g., letters from NASBA, NYSSCPA, CAQ, BDO, EY, KPMG, RSM, PwC, GT, FEI, and Crowe.

<sup>153</sup> See letter from FEI.

<sup>154</sup> See letter from Crowe.

One commenter requested that the Commission include in the adopting release the guidance discussed in Section II.B.2 of the Proposing Release regarding the situation where a borrower becomes a covered person only because of a change in the ownership in the loan.<sup>155</sup>

### **c. Final Amendment**

After considering the public comments and recommendations received, we are adopting as proposed the amendment to Rule 2-01(c)(1)(ii)(A)(I)(iv) to refer to “mortgage loans” instead of “a mortgage loan.” In response to the commenter who requested examples or guidance on the application of the mortgage loan exception when a borrower has obtained different types of loans collateralized by a primary residence, we note that the Commission has previously clarified that the rationale for the mortgage loan exception focuses on the status of the covered person at the time of the loan origination.<sup>156</sup> The same focus applies to second mortgages, home improvement loans, equity lines of credit, and similar mortgage obligations collateralized by a primary residence obtained from a financial institution under its normal lending procedures, terms and requirements and while the borrower is not a covered person in the firm.

Also, as noted in the Proposing Release,<sup>157</sup> where the borrower becomes a covered person only because of a change in the ownership in the loan, and provided 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, the loan would be included within this exception.

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<sup>155</sup> See letter from EY.

<sup>156</sup> See 2000 Adopting Release.

<sup>157</sup> Section II.B.2 of the Proposing Release.

Regarding a commenter’s suggestion to extend the mortgage loan exception to loans collateralized by a non-primary residence (*e.g.*, a secondary or vacation home), we believe excepting loans on non-primary residences, which may be held for investment, would introduce increased risk to an auditor’s objectivity and impartiality. As such, we do not see a compelling reason to expand the exception as suggested.

**3. Amendment to Revise the Credit Card Rule to Refer to “Consumer Loans”**

**a. Proposed Amendment**

The Commission proposed revising 17 CFR 210.2-01(c)(1)(ii)(E) (“Rule 2-01(c)(1)(ii)(E)”) (the “Credit Card Rule”) to replace the reference to “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. The Proposing Release set forth the Commission’s view that a limited amount of debt that is routinely incurred by a covered person or any of his or her immediate family members for personal consumption, even if the audit client is the lending entity, would typically not impair an auditor’s objectivity and impartiality. The proposed amendment would expand the current Credit Card Rule to encompass the types of consumer financing borrowers routinely obtain for personal consumption, such as, for example, retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence. The Proposing Release explained that the types of consumer loans contemplated, like credit cards, would typically have a payment due date (*e.g.*, monthly).<sup>158</sup>

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<sup>158</sup> Section II.B.3 of the Proposing Release.

## b. Comments Received

All commenters that addressed this proposed amendment expressed their support.<sup>159</sup> We received no comments that specifically opposed this proposed amendment. Some commenters supported the proposed \$10,000 limit,<sup>160</sup> while other commenters recommended raising the limit to \$20,000 to account for inflation.<sup>161</sup> One commenter suggested an increase to \$20,000 or \$25,000 while citing to recent studies about consumer finances.<sup>162</sup> Some commenters encouraged the Commission to consider adjustments of the dollar threshold to account for inflation.<sup>163</sup> A few commenters requested that the Commission reconsider the limit, but did not suggest an alternative amount.<sup>164</sup>

In the Proposing Release, the Commission requested comment on whether further guidance was needed with respect to the reference to current basis. Some commenters indicated that the term “current basis” does not require further guidance.<sup>165</sup> A few commenters stated that the term “consumer loans” is well understood and does not require further defining,<sup>166</sup> while other commenters stated that further guidance is needed.<sup>167</sup> One commenter recommended that

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<sup>159</sup> See e.g., letters from NASBA, NYSSCPA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Crowe, ICI/IDC, IBC, FEI, Fund AC Chairs, and Law Office of Edward B. Horahan III (Mar. 12, 2020) (“Horahan”).

<sup>160</sup> See e.g., letters from NYSSCPA and Crowe.

<sup>161</sup> See e.g., letters from BDO and EY.

<sup>162</sup> See letter from Horahan.

<sup>163</sup> See e.g., letters from CAQ, PwC, and RSM.

<sup>164</sup> See e.g., letters from KPMG and IBC.

<sup>165</sup> See e.g., letters from BDO, KPMG, RSM, and EY.

<sup>166</sup> See e.g., letters from BDO and EY.

<sup>167</sup> See e.g., letters from KPMG, RSM, IBC, and PwC.

the Commission define the term “consumer loan” along the lines of the discussion in the Proposing Release and suggested that the rule retain a reference to “credit cards” for additional clarity.<sup>168</sup> Another commenter suggested the Commission use the term “other consumer loans” because, in its view, consumer loans commonly include auto, home equity, and student loans and mortgages.<sup>169</sup> Some commenters requested that the Commission consider whether similar exclusions should be applied to other consumer financial arrangements, such as digital payment application balances,<sup>170</sup> deposit overdraft protections,<sup>171</sup> insurance policies, leases, and deposit account balances that exceed FDIC insurance limits or are not subject to FDIC or similar insurance.<sup>172</sup>

### **c. Final Amendment**

After considering the public comments and recommendations received, we are adopting as proposed amended 17 CFR 210.2-01(c)(1)(ii)(E). The amendment is intended to broaden this provision so that credit card debt and other forms of consumer financing, such as retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence, would be excluded if the outstanding balance is \$10,000 or less on a current basis. Consistent with the payment terms in the current Credit Card Rule, in assessing the current basis of a consumer loan balance, the borrower would consider the payment due date, plus any available grace period, which is typically monthly for credit cards. We

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<sup>168</sup> See letter from PwC.

<sup>169</sup> See letter from RSM.

<sup>170</sup> See letter from FEI.

<sup>171</sup> See e.g., letters from PwC, KPMG, and FEI.

<sup>172</sup> See letter from PwC.

considered inflationary adjustments in light of comments received asking for an increase from the proposed \$10,000 outstanding balance limit. However, we are not modifying the proposed outstanding balance limit because we believe \$10,000 remains a significant amount of money for an individual covered by the final amendment (*i.e.*, any covered person or his or her immediate family members). In particular, we believe that when an individual covered by the final amendment has outstanding consumer loan(s) with an audit client in excess of this amount, the auditor's objectivity and impartiality could be impaired.

The additional exclusions suggested by commenters for other consumer financial arrangements, such as digital payment application balances, among others, were not included as part of the proposal and may involve their own unique set of issues. Accordingly, the final amendment does not cover such arrangements. Also, we believe including many enumerated types of consumer loans in the rule will increase complexity of the rule and may become outdated as consumer lending arrangements evolve. As such, we have not included within Rule 2-01(f) a definition of the term "consumer loan." We also did not adopt commenters' suggestions to use a term other than "consumer loans," such as to retain the current reference to "credit cards" or to add "other," as we believe the rule is sufficiently clear as to what types of loans are covered under this exception.

### **C. Amendments to the Business Relationships Rule**

#### **1. Proposed Amendment to the Reference to "Substantial Stockholder"**

The Commission proposed to replace the term "substantial stockholders" in the Business Relationships Rule with the phrase "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client." Currently, Rule 2-01(c)(3) prohibits, at any point during the audit and professional

engagement period, the accounting firm or any covered person from having “any direct or material indirect business relationship with an 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* . . . .” (emphasis added).

In the Proposing Release, the Commission expressed its belief that referring to “beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client” instead of “substantial stockholders” would improve the rule by making it clearer and less complex. In this regard, the Commission noted that “substantial stockholder” is not currently defined in Regulation S-X, whereas the concept of significant influence is used in the Loan Provision<sup>173</sup> and other aspects of the auditor independence rules.<sup>174</sup>

The Proposing Release also included additional guidance to explain that regardless of whether the beneficial owner owns equity securities of an audit client, including an affiliate of the audit client, the independence analysis should focus on whether the beneficial owner has significant influence over the entity under audit, as business relationships with persons with such influence could be reasonably expected to affect an auditor’s objectivity and impartiality.<sup>175</sup>

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<sup>173</sup> Consistent with the recently adopted amendments discussed in the Loan Provision Adopting Release, the Commission indicated that use of “significant influence” in the proposed amendments is intended to refer to the principles in the Financial Accounting Standards Board’s (“FASB’s”) ASC Topic 323, Investments – Equity Method and Joint Ventures. *See* Section II.C.3 of the Loan Provision Adopting Release.

<sup>174</sup> *See e.g.*, Rules 2-01(f)(4)(ii) and (iii).

<sup>175</sup> *See* Section II.C.2 of the Proposing Release. This guidance was limited to the analysis related to associated persons in a decision-making capacity of an audit client. This guidance was not intended to change the analysis when evaluating “any direct or material indirect business relationships with an audit client.” Under the current, proposed, and adopted rule, any direct or material indirect business relationships with an audit client, which includes any affiliates of the audit client, would be deemed independence-impairing.

## 2. Comments Received

Many commenters supported the proposal to use the significant influence concept from the Loan Provision to replace the reference to substantial stockholder in the Business Relationships Rule.<sup>176</sup> Commenters stated that this approach would facilitate compliance by applying a concept that is well understood.<sup>177</sup> Some commenters indicated the proposal would more appropriately identify those relationships that are more likely to impair an auditor's objectivity and impartiality<sup>178</sup> and would increase the number of qualified firms from which an issuer may choose.<sup>179</sup>

One commenter opposed the proposed amendment.<sup>180</sup> This commenter reiterated concerns regarding the concept of beneficial owner with significant influence, which the commenter previously expressed with respect to the recent amendments to the Loan Provision.<sup>181</sup>

Several commenters recommended that the Commission consider aligning the guidance in the Proposing Release with the Loan Provision Adopting Release to clarify that entities under common control with, or controlled by, the beneficial owner of the audit client's equity securities

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<sup>176</sup> See e.g., letters from NASBA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Parrett, AIC, ICI/IDC, IBC, FEI, CCMC and Crowe.

<sup>177</sup> See e.g., letters from CAQ, Deloitte, EY, KPMG, PwC, ICI/IDC, and Crowe.

<sup>178</sup> See e.g., letters from CAQ, Deloitte, ICI/IDC, EY, FEI, KPMG, RSM, PwC, and Crowe.

<sup>179</sup> See letter from EY.

<sup>180</sup> See letter from CII.

<sup>181</sup> See letter from CII (June 28, 2018), available at <https://www.sec.gov/comments/s7-10-18/s71018-3969965-167120.pdf>.



that has significant influence over the audit client would be excluded from the scope of the Business Relationships Rule.<sup>182</sup>

One commenter requested that the Commission provide examples of the types of business relationships that would be “problematic” based on consultations received.<sup>183</sup>

In the Proposing Release, the Commission requested comment on whether additional amendments are needed to address multi-company relationships. Commenters provided their views concerning multi-company relationships, including, for some, the application of Rule 2-01(b) to these situations.<sup>184</sup> These commenters suggested that the Commission consider these discussions and examples when considering whether to provide future guidance in this area. Some commenters explicitly noted that they do not believe further amendments are required to identify whether the auditor’s objectivity and impartiality would be impaired.<sup>185</sup>

One commenter suggested a broad re-examination of the Business Relationships Rule due to the changes in the business environment and multi-company relationships.<sup>186</sup> Another commenter stated that Rule 2-01(c)(3) currently precludes many private equity firms from investing in certain multi-company relationships and that the proposed amendments do not

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<sup>182</sup> See e.g., letters from CAQ, Deloitte, EY, AIC, CCMC, PwC, and Parrett. FEI also requested alignment with the Loan Provision Adopting Release, but did not specify the common control issue.

<sup>183</sup> See letter from GT. We have not provided examples of problematic business relationships as requested by the commenter. The changes to the Business Relationships Rule set forth in this release are narrow and consistent with the Loan Provision. Providing examples or additional guidance on the broader application of Rule 2-01(c)(3) is beyond the scope of this rulemaking. As noted in Section II.A.1.a.iii and consistent with the introductory paragraph to amended Rule 2-01, registrants and auditors may consult with the Commission’s Office of the Chief Accountant.

<sup>184</sup> See e.g., letters from CAQ, Deloitte, EY, KPMG, RSM, and PwC.

<sup>185</sup> See e.g., letter from EY and KPMG.

<sup>186</sup> See letter from PwC.

address this issue.<sup>187</sup> This same commenter also noted that its recommendation to apply a dual materiality threshold in determining if a sister entity is an affiliate of the audit client would significantly alleviate the concerns around the Business Relationships Rule.

With respect to the additional guidance in the Proposing Release, many commenters expressed their support for the clarification that the focus of the significant influence analysis, as it relates to persons in a decision-making capacity, should be on the entity under audit.<sup>188</sup> Commenters also recommended that the Commission reiterate this guidance in the adopting release or revise the rule text to incorporate it.<sup>189</sup>

Two commenters requested that the Commission clarify whether this “entity under audit” guidance applies to officers and directors as referenced in the Business Relationships Rule.<sup>190</sup>

### **3. Final Amendments**

After considering the public comments and recommendations received, we are adopting amendments to the Business Relationships Rule substantially as proposed with one modification. We are modifying the proposal to incorporate the guidance in the Proposing Release regarding the reference to “audit client” when identifying associated persons in a decision-making capacity, including beneficial owners. Under this approach, the independence analysis focuses on whether the associated person has decision-making capacity over the entity under audit rather than the audit client. We continue to believe that providing internal consistency between the Loan Provision and the Business Relationships Rule by leveraging the concept of “beneficial

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<sup>187</sup> See letter from AIC.

<sup>188</sup> See e.g., letters from NASBA, CAQ, Deloitte, BDO, EY, KPMG, PwC, GT, CCMC, and Crowe.

<sup>189</sup> See e.g., letters from CAQ, Deloitte, KPMG, Crowe, CCMC, PwC, and GT.

<sup>190</sup> See letters from EY and PwC.

owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence” will foster compliance and consistency in application.

Regarding the comments seeking consistency with the Loan Provision in other areas, we do not agree with the recommendation that entities controlled by or under common control with the beneficial owner of the audit client’s equity securities, where such beneficial owner has significant influence over the entity under audit, should be excluded from the scope of the Business Relationships Rule. We view business relationships as presenting different threats to an auditor’s objectivity and impartiality than those presented by lending relationships. We also believe the focus on beneficial owners having significant influence over the entity under audit instead of the audit client properly focuses the independence analysis on the significant threats to an auditor’s objectivity and impartiality—and identifying associated persons with such influence should not impose an undue compliance burden.

We agree with commenters that requested we codify the additional guidance from the Proposing Release to provide more certainty regarding the application of the final amendment to beneficial owners of equity securities of an affiliate of the audit client. As such, the final amendment to the Business Relationships Rule has been modified to refer to “beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the *entity under audit*” (emphasis added). Further, in response to comments seeking clarification regarding the application of the Business Relationships Rule to officers and directors, we are also amending the Business Relationships Rule to refer to “an audit client’s officers or directors that have the ability to affect decision-making at the entity under audit.” This amendment clarifies that the Business Relationships Rule applies to relationships with officers or directors at an affiliate of the audit client when such

person has the ability to affect decision-making at the entity under audit. This amendment does not change the application of the rule as it applies to the officers or directors of the entity under audit. Such persons are deemed to have the ability to affect decision-making at the entity under audit.

Although we requested comment on the need to address multi-company arrangements, after further consideration, we have determined that addressing such arrangements is beyond the scope of this rulemaking, which is focused on aligning the Business Relationships Rule with the Loan Provision and providing clarification regarding persons in a decision-making capacity. For similar reasons, we are not providing examples of problematic business relationships, as requested by one commenter. We also agree with the commenter that indicated that the proposed amendments to the affiliate of the audit client definition should significantly alleviate concerns around the Business Relationships Rule.<sup>191</sup> If auditors or their clients have specific questions related to multi-company arrangements, as noted in the introductory paragraph to amended Rule 2-01, they may consult with the Commission's Office of the Chief Accountant.

#### **4. Conforming Amendments to the Loan Provision**

The additional guidance provided in the Proposing Release regarding beneficial owners with significant influence set forth the Commission's view of the appropriate application of the Loan Provision. For clarity, we are adopting conforming amendments to the Loan Provision to reflect our view of how it applies to loans to or from officers or directors of affiliates of the audit client and beneficial owners of an affiliate of the audit client's equity securities.

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<sup>191</sup> See letter from AIC.

## **D. Amendments for Inadvertent Violations for Mergers and Acquisitions**

### **1. Proposed Amendment**

For the reasons discussed in the Proposing Release,<sup>192</sup> the Commission introduced a transition framework to address inadvertent independence violations where the independence violation arises as a result of a corporate event, such as a merger or acquisition, and the services or relationships that are the basis for the violation would not have run afoul of applicable independence standards prior to the corporate event. The proposed amendments would require an auditor to:

- Be in compliance with the applicable independence standards related to the services or relationships when the services or relationships originated and throughout the period in which the applicable independence standards apply;
- Correct the independence violations arising from the merger or acquisition as promptly as possible under relevant circumstances associated with the merger or acquisition; and
- Have in place a quality control system as described in 17 CFR 210.2-01(d)(3) (“Rule 2-01(d)(3)”) that has the following features:
  - Procedures and controls that monitor the audit client’s merger and acquisition activity to provide timely notice of a merger or acquisition; and
  - Procedures and controls that allow for prompt identification of potential violations after initial notification of a potential merger or acquisition that may trigger independence violations, but before the transaction has occurred.

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<sup>192</sup> See Section II.D of the Proposing Release.

## 2. Comments Received

Many commenters supported the proposed transition framework to allow audit firms and their clients to transition out of services or relationships that will become violations due to a merger or acquisition.<sup>193</sup> Commenters indicated that these inadvertent violations would not typically impair an auditor's objectivity and impartiality.<sup>194</sup> Some commenters also noted the potential for significant disruption when these situations arise through no action of the audit firm.<sup>195</sup> One commenter discussed disruption in the context of the private equity space.<sup>196</sup> Another commenter stated that the proposed transaction framework may increase the number of auditors a potential audit client may select or retain.<sup>197</sup>

A few commenters opposed the proposed transition framework.<sup>198</sup> One commenter indicated that it generally does not view a delay in mergers and acquisitions due to independence matters as a "possible detriment" to investors because auditor independence is critical to investor protection and investor confidence and it believes that "many, if not most, mergers and acquisitions ultimately do not enhance long-term shareholder value."<sup>199</sup> Another commenter indicated that it could not support the proposal "without additional guardrails."<sup>200</sup> This

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<sup>193</sup> See e.g., letters from NASBA, CAQ, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, Parrett, AIC, ICI/IDC, IBC, FEI, CCMC, and Crowe.

<sup>194</sup> See e.g., letters from Deloitte, KPMG, Crowe, AIC, and GT.

<sup>195</sup> See e.g., letters from CAQ, Deloitte, EY, ICI/IDC, FEI, and AIC.

<sup>196</sup> See letter from AIC.

<sup>197</sup> See letter from KPMG.

<sup>198</sup> See e.g., letters from CII and NYSSCPA.

<sup>199</sup> See letter from CII.

<sup>200</sup> See letter from NYSSCPA.

commenter suggested that the relationship or service triggering the inadvertent violation should either be terminated before the merger or acquisition is effective, or within a specified period of time (*e.g.*, three months) from the announcement date of the merger or acquisition. The commenter further stated that the “as promptly as possible” provision is susceptible to abuse and that these situations are better addressed by the staff on a case by case basis as the issue arises.”

One commenter recommended that the proposed transition framework should be applicable to all financial statement periods subject to compliance with Rule 2-01, such as where an entity anticipating an IPO makes an acquisition in the year subject to the one-year look-back provision as proposed.<sup>201</sup> The commenter’s recommendation would allow a private company that engages in a merger or acquisition transaction to be able to rely on the transition framework to satisfy its independence requirements when it engages in an IPO in the following year.

Commenters generally supported the proposed quality control criteria or noted that they are sufficiently clear.<sup>202</sup> One commenter stated that the quality control requirement should acknowledge the applicability of the general standard with respect to the independence evaluation of the services and relationships with the new affiliate—both individually and in the aggregate.<sup>203</sup> Another commenter recommended that the Commission provide further guidance on the terms “timely notice” and “prompt identification” and its expectations of the procedures and controls that audit clients should have in place to inform auditors of pending transactions.<sup>204</sup>

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<sup>201</sup> See letter from KPMG.

<sup>202</sup> See *e.g.*, letters from Deloitte, BDO, KPMG, and RSM.

<sup>203</sup> See letter from KPMG.

<sup>204</sup> See letter from EY.

In the Proposing Release, the Commission requested comment on whether certain services or relationships should continue to be deemed independence-impairing, for example, if they result in the auditor auditing its own work. Some commenters indicated that Rule 2-01(b) appropriately addresses any threat to an auditor’s objectivity and impartiality in situations where an inadvertent violation from a merger or acquisition could result in an audit firm auditing its own work.<sup>205</sup> Another commenter stated that the threat of auditing one’s own work is mitigated by the proposed requirement to comply with applicable independence standards prior to the transaction and because periods prior to the transaction are not included in the accounting acquirer’s financial statements.<sup>206</sup> However, several commenters expressed the view that “under no circumstances should the auditor be permitted” to audit its own work.<sup>207</sup>

Some commenters stated that a merger or acquisition that is in substance more like an IPO should be addressed by the proposed change to the definition of the “audit and professional engagement period,” as the compliance challenges are similar to an IPO situation.<sup>208</sup> However, other commenters asserted that all mergers or acquisitions should be covered by the proposed transition framework, including transactions in which private companies merge into a public shell, as these types of reverse mergers can occur with much less notice than a traditional IPO.<sup>209</sup>

In the Proposing Release, the Commission requested comment on the requirement to correct inadvertent violations as “promptly as possible” and indicated that such correction should

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<sup>205</sup> See e.g., letters from Deloitte, EY, and KPMG.

<sup>206</sup> See letter from RSM.

<sup>207</sup> See e.g., letters from NASBA and CII.

<sup>208</sup> See e.g., letters from Deloitte and RSM.

<sup>209</sup> See e.g., letters from EY and KPMG.



not occur more than six months after the consummation of the merger or acquisition. Many commenters supported the maximum six-month transition period.<sup>210</sup> A few commenters recommended that the final rule expressly reference the six-month transition period.<sup>211</sup> One commenter expressed concern that the “maximum six-month transition period will become the acceptable standard in practice.”<sup>212</sup> One commenter suggested a 12- to 18-month maximum<sup>213</sup> while another commenter stated that a maximum period of time should not be specified.<sup>214</sup>

Several commenters suggested the Commission clarify that the framework applies where the triggering relationship or service is identified at or after the transaction closing but still addressed within the six-month window.<sup>215</sup> A few of these commenters noted that the quality control systems described in Rule 2-01(d)(3) may not, at times, identify independence-impairing relationships or services until after the close of a merger or acquisition.<sup>216</sup> Relatedly, some commenters indicated that there are challenges in obtaining relevant information prior to the closing of mergers or acquisitions.<sup>217</sup>

Several commenters questioned whether compliance with the proposed transition framework should still result in an independence violation, and stated their belief that parties that

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<sup>210</sup> See e.g., letters from CAQ, Deloitte, BDO, EY, KPMG, PwC, GT, AIC, ICI/IDC, and Crowe.

<sup>211</sup> See e.g., letters from PwC and EY.

<sup>212</sup> See letter from NASBA.

<sup>213</sup> See letter from IBC.

<sup>214</sup> See letter from RSM.

<sup>215</sup> See e.g., letters from CAQ, EY, PwC, GT, Crowe, AIC, ICI/IDC, FEI, CCMC, and KPMG.

<sup>216</sup> See e.g., letters from EY and KPMG.

<sup>217</sup> See e.g., letters from PwC, GT, and FEI.

adhere to the framework should not be viewed as having incurred an independence violation.<sup>218</sup>

Some of these commenters requested that the Commission use terms other than “violation” and “lack of independence” when discussing potentially independence-impairing relationships or services prior to the closing of a transaction.<sup>219</sup> One of these commenters noted that since the relationships or services are identified before the closing, it does not appear they should be called violations, since they are not technically violations until the merger or acquisition closes.<sup>220</sup>

A few commenters requested guidance on how matters covered by the proposed transition framework should be communicated to an audit committee.<sup>221</sup> One commenter indicated that if these matters are not deemed violations, then the matters would not be communicated to the audit committee.<sup>222</sup> However, other commenters asserted that even if these matters are not deemed violations, the matters should still be communicated to the audit committee.<sup>223</sup>

### **3. Final Amendments**

After considering the public comments and recommendations received, we are adopting amended 17 CFR 210.2-01(e) (“amended Rule 2-01(e)”) substantially as proposed to include a transition provision for inadvertent independence violations where the independence violation arises as a result of a corporate event, such as a merger or acquisition, involving audit clients.

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<sup>218</sup> See e.g., letters from CAQ, Deloitte, BDO, EY, CCMC, KPMG, Crowe, and PwC.

<sup>219</sup> See e.g., letters from Crowe and KPMG.

<sup>220</sup> See letter from KPMG.

<sup>221</sup> See e.g., letters from GT and Crowe.

<sup>222</sup> See letter from PwC.

<sup>223</sup> See e.g., letters from EY and CCMC.

We are adopting modifications from the proposed amendments to address comments received regarding the reference to “lack of independence” and “violation” in the proposed amendment that we found persuasive. For clarity, we also are replacing “before the transaction has occurred” with “before the effective date of the transaction.” The effective date of a merger or acquisition is typically identified in the transaction documents and often made public. This change is not intended to alter the application of the rule from the proposal, but only to provide clarity and consistency with commonly used terms.

We continue to believe it is appropriate to provide, in a manner consistent with investor protection, a transition framework for mergers and acquisitions to address inadvertent violations as a result of such transactions so the auditor and its audit client can transition out of services and relationships that would currently trigger an independence violation in an orderly manner. As stated in the Proposing Release, the transition framework follows the consideration of the audit firm’s quality controls similar to Rule 2-01(d)(3).<sup>224</sup> As proposed, we are adopting the requirements associated with the transition framework.

As noted above, the Commission requested comment regarding mergers and acquisitions that are similar to IPOs. After considering the feedback received, we believe that the adopted transition framework should not apply to merger or acquisition transactions that are in substance similar to IPOs. For example, where a shell company, reporting pursuant to Sections 13 or 15(d) of the Exchange Act, engages in a merger with a private operating company, the auditor of the

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<sup>224</sup> The Commission adopted 17 CFR 210.2-01(d) (“Rule 2-01(d)”) as a limited exception to address a covered person’s violations in certain circumstances that would be attributed to an entire firm. The effect of Rule 2-01(d) is that an accounting firm with “appropriate quality controls will not be deemed to lack independence when an accountant did not know of the circumstances giving rise to the impairment, and upon discovery, the impairment is quickly resolved.” *See* 2000 Adopting Release, at 65 FR 76052.

financial statements to be included in a Commission filing resulting from such transaction will not be able to rely on the transition framework in amended Rule 2-01(e). Instead, such auditor should evaluate independence compliance using the look-back period contained within the “audit and professional engagement period” definition, as amended.<sup>225</sup> Consistent with the introductory paragraph in amended Rule 2-01, registrants and auditors may also consult with the Commission’s Office of the Chief Accountant.

**a. Amended Rule 2-01(e)(1) - Compliance with All Applicable Independence Standards**

Regarding this first provision, amended 17 CFR 210.2-01(e)(1) (“amended Rule 2-01(e)(1)”), the auditor must be in compliance with any independence standards that are applicable to the entities involved in the merger or acquisition transaction from the origination of the relationships or services in question and throughout the period in which the applicable independence standards apply.

**b. Amended 17 CFR 210.2-01(e)(2) - Prompt Transition**

We expect that the independence-impairing service or relationship, in most instances, should and could be addressed before the effective date of the merger or acquisition. However, we understand there may be situations where it might not be possible for the audit client and the auditor to transition the independence-impairing service or relationship in an orderly manner without causing significant disruption to the audit client. In those situations, we expect the relationship or service to be addressed promptly after the effective date of the merger or acquisition.

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<sup>225</sup> See Section II.A.2.c.

Whether a post-transaction transition occurs promptly will depend on all relevant facts and circumstances. However, as stated in the Proposing Release, we expect any necessary actions would be taken no later than six months after the effective date of the merger or acquisition. We have not included a reference to the six-month maximum transition period in amended Rule 2-01(e), as suggested by some commenters, because we do not intend, nor do we believe it would be appropriate, for audit clients and audit firms to apply this timeline to address such services or relationships in every merger or acquisition scenario. In this regard, we agree with the commenter who suggested that specifying such a timeline in the final rule could result in it becoming the standard practice in all situations, even when a shorter transition may be reasonably attainable and more appropriate.

We also are not specifying a longer maximum transition period as several commenters recommended. We continue to believe that six months is an appropriate limit for transitioning to compliance with our independence rules, which as noted above, are important for investor protection and to promote investor confidence. As stated in the Proposing Release, audit firms and audit clients already manage to this timeline as it is consistent with international ethics and independence standards for accountants.<sup>226</sup>

In response to comments, we are removing references to the services and relationships identified as a result of a merger or acquisition as a “lack of independence” or “violation.” We agree that if the requirements in amended Rule 2-01(e) are met, then the relationships and services are not independence violations. As such, referring to independence violations or lack of independence may be confusing. The transition framework is intended to allow an auditor and

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<sup>226</sup> See The International Code of Ethics for Professional Accountants (including International Independence Standards), section titled, “Mergers and Acquisitions” under, “Part 4A-Independence for Audit and Review Engagements” available at [https://www.ifac.org/system/files/publications/files/Final-Pronouncement-The-Restructured-Code\\_0.pdf](https://www.ifac.org/system/files/publications/files/Final-Pronouncement-The-Restructured-Code_0.pdf).

its audit client sufficient opportunity to transition out of services and relationships in an orderly manner without impairing the auditor's independence. With respect to comments regarding whether these services or relationships should be communicated to the audit committee, auditors should follow PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. PCAOB Rule 3526 requires communications of all relationships that may reasonably be thought to bear on independence.

**c. New 17 CFR 210.2-01(e)(3) - Quality Control System**

We considered comments received requesting elimination of the proposed requirement for an accounting firm to have procedures and controls to identify independence-impairing services and relationships before the transaction has occurred in order to allow for post-transaction identification. We are not adopting this suggestion. The Commission continues to stress that having a robust quality control system is paramount to maintaining auditor independence and, ultimately, investor protection.

We believe that it is reasonable to expect that an auditor and an audit client intending to rely on the benefits of the transition framework have in place robust procedures and controls that will identify services and relationships that would result in an independence violation prior to the effective date of the triggering transactions. As such, we are adopting the transition framework, as proposed, with a slight modification regarding the reference to "effective date" discussed above, so that it applies to services and relationships that are identified prior to the effective date of a merger or acquisition transaction.

In situations where a service or relationship resulting in an independence violation is identified subsequent to the effective date of the transaction, an audit firm and the audit client's audit committee will need to take into account all relevant facts and circumstances in their

evaluation of the auditor's objectivity and impartiality in carrying out an audit of the financial statements of the combined entity. Consistent with the introductory paragraph in amended Rule 2-01, registrants and auditors may also consult with the Commission's Office of the Chief Accountant.

Regarding the suggestion that the quality control requirement acknowledge the applicability of Rule 2-01(b), we do not feel this is necessary. Rule 2-01(b) applies in all cases and expressly requires the consideration of all relevant facts and circumstances. As a result, if the transition framework is followed but the nature, extent, relative importance, or other aspect of the service or relationship impairs the auditor's objectivity and impartiality, then that service or relationship would be considered an independence violation. For example, if an auditor is found to be auditing its own work over a significant amount of the acquired business as part of the audit of the financial statements, that fact most likely would affect the auditor's independence under Rule 2-01(b).

## **E. Miscellaneous Amendments**

### **1. Proposed Miscellaneous Amendments**

As discussed in Section II.E of the Proposal, the Commission proposed three miscellaneous amendments to:

- Make conforming amendments throughout Rule 2-01 to replace references to "concurring partner" with the term "Engagement Quality Reviewer" to be consistent with current auditing standards that use the term "Engagement Quality Reviewer" or "Engagement Quality Control Reviewer;"
- Convert the existing Preliminary Note to §210.2-01 into introductory text to Rule 2-01, consistent with *Federal Register* drafting requirements; and

- Delete the outdated transition provisions in existing Rule 2-01(e), which were added as part of the Commission’s 2003 amendments<sup>227</sup> to address the existence of relationships and arrangements that predated those amendments.

## **2. Comments Received**

Commenters that addressed this aspect of the proposal supported the proposed miscellaneous amendments.<sup>228</sup> No commenters expressed opposition to any of the three proposed miscellaneous amendments. Related to our technical amendment to re-designate the Preliminary Note to §210.2-01, one commenter requested we repeat at the adopting stage our discussion in the Proposing Release that the amendment does not affect the application of the auditor independence rules.<sup>229</sup>

## **3. Final Amendments**

We are adopting the three miscellaneous amendments as proposed. As noted in the Proposing Release,<sup>230</sup> the final amendment to convert the existing Preliminary Note to §210.2-01 into introductory text does not affect the application of the auditor independence rules and is simply a change in rule text format.

## **F. Other Comments Received**

Several commenters requested that the Commission collaborate with the PCAOB to evaluate and update the PCAOB independence rules and standards in light of the proposed

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<sup>227</sup> See *supra* note 6.

<sup>228</sup> See *e.g.*, letters from NASBA, Deloitte, BDO, EY, KPMG, RSM, PwC, GT, and CCMC.

<sup>229</sup> See letter from KPMG.

<sup>230</sup> See Section II.E.2 of the Proposing Release.



amendments if the proposed amendments are adopted.<sup>231</sup> For example, PCAOB Rule 3500T provides that registered public accounting firms must comply with the more restrictive independence rule if there are differences between the SEC and PCAOB independence rules. As a result of the final amendments, there will be differences between the SEC and PCAOB independence rules. The PCAOB has publicly disclosed a plan to conform its independence rules in response to the final amendments.<sup>232</sup>

### **G. Transition**

Auditors currently subject to the independence requirements of Rule 2-01 are not required to apply the final amendments until [INSERT DATE 180 DAYS AFTER THE DATE PUBLISHED IN THE FEDERAL REGISTER] in order to have sufficient time to develop and implement processes and controls based on the final amendments. Voluntary early compliance is permitted after the amendments are published in the *Federal Register* in advance of the effective date provided that the final amendments are applied in their entirety from the date of early compliance.<sup>233</sup>

Compliance with the final amendments is required on a prospective basis from the earlier of the effective date or early compliance date if selected by an audit firm. Auditors are not permitted to retroactively apply the final amendments to relationships and services in existence prior to the effective date or the early compliance date if selected by an audit firm. Regarding the final amendments in Rule 2-01(c)(1)(ii)(A) and (E) and loans that were originated before the

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<sup>231</sup> See e.g., letters from CAQ, EY, GT, PwC, RSM, AIC, and CCMC.

<sup>232</sup> See <https://pcaobus.org/Standards/research-standard-setting-projects/Pages/auditor-independence.aspx>.

<sup>233</sup> To the extent that auditors or audit clients have questions about application of the rules in connection with early compliance, they may contact staff in the Office of the Chief Accountant for additional transition guidance.

effective date or the early compliance date, but that comply with the conditions of the final amendments as of the effective date or early compliance date, an auditor may rely on the final amendments; such loans would not be considered independence violations provided the conditions for excepting such loans continue to be met.

### **III. OTHER MATTERS**

If any of the provisions of these amendments, or the application of these provisions to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application. Pursuant to the Congressional Review Act,<sup>234</sup> the Office of Information and Regulatory Affairs has designated these amendments as [not] a “major rule,” as defined by 5 U.S.C. 804(2).

### **IV. ECONOMIC ANALYSIS**

#### **A. Introduction**

We are adopting amendments to the auditor independence requirements in Rule 2-01 that will: (1) amend the definition of an affiliate of the audit client to address certain affiliate relationships in common control scenarios and the ICC definition; (2) shorten the look-back period for domestic first-time filers in assessing compliance with the independence requirements; (3) add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships; (4) replace the reference to “substantial stockholders” in the Business Relationships Rule with the concept of beneficial owners with significant influence; (5) introduce a transition framework for merger and acquisition

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<sup>234</sup> 5 U.S.C. 801 *et seq.*

transactions to consider whether an auditor's independence is impaired; and (6) make certain miscellaneous amendments.

We are mindful of the costs and benefits of the final amendments. The discussion below addresses the potential economic effects of the final amendments, including the likely benefits and costs, as well as the likely effects on efficiency, competition, and capital formation.<sup>235</sup>

We note that, where possible, we have attempted to quantify the benefits, costs, and effects on efficiency, competition, and capital formation expected to result from the final amendments. In many cases, however, we are unable to quantify the economic effects because we lack information necessary to provide a reasonable estimate. For example, we are unable to quantify, with precision, the costs to auditors and audit clients of complying with the particular aspects of the auditor independence rules and the potential compliance cost savings, increase in the number of eligible auditors and potential clients, and changes in audit quality that may arise from the amendments to Rule 2-01. In the Proposing Release, we requested data to help us quantify the economic effects of the amendments, but none of the commenters provided any data or quantitative estimates.

The remainder of the economic analysis presents the baseline, anticipated benefits and costs from the final amendments, potential effects of the amendments on efficiency, competition and capital formation, and reasonable alternatives to the amendments.

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<sup>235</sup> Section 2(b) of the Securities Act [15 U.S.C. 77b(b)], Section 3(f) of the Exchange Act [17 U.S.C. 78c(f)], Section 2(c) of the Investment Company Act [15 U.S.C. 80a-2(c)], and Section 202(c) of the Investment Advisers Act [15 U.S.C. 80b-2(c)] require the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Further, Section 23(a)(2) of the Exchange Act [17 U.S.C. 78w(a)(2)] requires the Commission, when making rules under the Exchange Act, to consider the impact that the rules would have on competition, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the Exchange Act.

## **B. Baseline and Affected Parties**

Under current Rule 2-01, the term “affiliate of the audit client” includes “an entity that has control over the audit client or over which the audit client has control” and entities “under common control with the audit client, including the audit client’s parents and subsidiaries.”<sup>236</sup> Under this definition, affiliates of the audit client include all sister entities without regard to the materiality of the sister entity or the entity under audit to the controlling entity. The term “affiliate of the audit client” also includes each entity in an ICC when the audit client is part of the ICC.<sup>237</sup> In complex organizational structures, such as large ICCs, the requirement to identify and monitor for potential independence-impairing relationships and services currently applies to affiliated entities, including sister entities, regardless of whether the affiliated entities are material to the controlling entity. The current inclusion of sister entities that are not material to the controlling entity in the auditor independence analysis creates practical challenges and imposes compliance costs on both auditors and audit clients, especially those within complex organizational structures.

Currently, “audit and professional engagement period” is defined differently for first-time filers, depending on whether they are domestic issuers or FPIs.<sup>238</sup> Specifically, when a domestic IPO registration statement includes either two or three years of audited financial statements, the auditor of a domestic first-time filer must comply with Rule 2-01 for all audited financial

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<sup>236</sup> Rule 2-01(f)(4)(i).

<sup>237</sup> See Rule 2-01(f)(4)(iv).

<sup>238</sup> See Rule 2-01(f)(5)(iii).

statement periods included in such registration statement.<sup>239</sup> For FPIs, the corresponding “audit and professional engagement period” includes only the fiscal year immediately preceding the initial filing of the registration statement or report. As a result, domestic issuers may have a higher compliance cost relative to FPIs in applying this rule.

Pursuant to Rule 2-01(c), an accountant is not independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loans (including any margin loans) to or from an audit client, or certain other entities or persons related to the audit client.<sup>240</sup> Those loans include, among others, student loans, certain mortgage loans, and credit card balances. In addition, under current rules, a business relationship between a substantial stockholder of the audit client, among others, and the auditor or covered person would be considered independence-impairing.<sup>241</sup>

Certain aspects of Rule 2-01 require auditor independence compliance during the audit and professional engagement period, which may include periods before, during, and after merger and acquisition transactions.<sup>242</sup> As a result, certain merger and acquisition transactions could give rise to inadvertent violations of the auditor independence requirements. For example, an auditor may provide management functions to a target firm and auditing services to an acquirer prior to the occurrence of an acquisition. Consequently, the acquisition may result in an auditor independence violation that had not existed prior to the acquisition.

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<sup>239</sup> For example, an auditor may be excluded from consideration if the auditor provided a non-audit service (e.g., management functions) to a domestic filer in the third year before the firm files the registration statement for the first time. Even though the auditor has stopped providing such service to the filer starting two years prior to the firm’s filing the registration statement, under the current definition, the auditor will not qualify as “independent” under Rule 2-01.

<sup>240</sup> Rule 2-01(c)(1)(ii)(A).

<sup>241</sup> See Rule 2-01(c)(3).

<sup>242</sup> See Rule 2-01(f)(5).

The amendments will update the auditor independence requirements, which will affect auditors, audit clients, and any other entity that is currently or may become an affiliate of the audit client. Other parties that may be affected by the amendments include “covered persons” of accounting firms and their immediate family members. As discussed further below, the amendments will affect investors indirectly.

We are not able to reasonably estimate the number of current audit engagements that will be immediately affected by the amendments as we lack relevant data about such engagements. We also do not have precise data on audit clients’ ownership and control structures. With respect to the amendments relating to treatment of student loans and consumer loans, there is no data readily available to us relating to how “covered persons” and their immediate family members arrange their financing. Similarly, there is no readily available data to quantify the number of business relationships that audit firms have with beneficial owners of an audit client’s equity securities where the beneficial owner has significant influence over the audit client. As such, we are not able to identify those auditor-client relationships that would be impacted by the amendments to the Business Relationships Rule. We therefore are not able to quantify the effects of these aspects of the amendments. In the Proposing Release, we requested data in connection with the request for comment on all aspects of the economic analysis,<sup>243</sup> but none of the commenters provided any data or quantitative estimates with respect to these aspects of the amendments.

We have relied on information from PCAOB Forms 2 to approximate the potential

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<sup>243</sup> See Section III.F of the Proposing Release.

universe of auditors that will be affected by the amendments.<sup>244</sup> According to aggregated information from PCAOB Forms 2, as of August 3, 2020, there were 1,729 audit firms registered with the PCAOB (of which 876 are domestic audit firms, with the remaining 853 audit firms located outside the United States). According to a report provided by Audit Analytics in 2020, the four largest accounting firms audit about 73% of accelerated and large accelerated filers<sup>245</sup> and about 49.2% of all registrants.<sup>246</sup>

We estimate that approximately 6,792 issuers filing on domestic forms<sup>247</sup> and 849 FPIs filing on foreign forms would be affected by the amendments.<sup>248</sup> Among the issuers that file on domestic forms, approximately 31% are large accelerated filers, 19% are accelerated filers, and 50% are non-accelerated filers.<sup>249</sup> In addition, we estimate that approximately 19.1% of

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<sup>244</sup> All registered public accounting firms must file annual reports on Form 2 with the PCAOB. To determine the number of audit firms registered with the PCAOB, we aggregated the total number of entities who filed a Form 2 with the PCAOB.

<sup>245</sup> Accelerated filers and large accelerated filers are defined in Rule 12b-2 of the Exchange Act of 1934 [17 CFR 240.12b-2].

<sup>246</sup> See *Who Audits Public Companies-2020 Edition*, available at <https://blog.auditanalytics.com/who-audits-public-companies-2020-edition>; see also Daniel Hood, “Top firms’ share of public co. audits creeps up,” *Accounting Today* (June 5, 2020), available at: <https://www.accountingtoday.com/news/top-firms-share-of-public-co-audits-creeps-up>.

<sup>247</sup> This number includes fewer than 25 foreign issuers that file on domestic forms and approximately 100 business development companies.

<sup>248</sup> The number of issuers that file on domestic forms is estimated as the number of unique issuers, identified by Central Index Key (CIK), that filed Forms 10-K, or an amendment thereto, with the Commission during calendar year 2019. The number of foreign private issuers is estimated as the number of unique issuers, identified by CIK, that filed either Form 20-F, 40-F, or an amendment thereto, with the Commission during calendar year 2019. Of FPIs with a self-reported status, approximately 37% are large accelerated filers, 21% are accelerated filers, and 42% are non-accelerated filers. Additionally, 26% are emerging growth companies.

<sup>249</sup> The estimates for the percentages of smaller reporting companies, accelerated filers, large accelerated filers, and non-accelerated filers are based on data obtained by Commission staff using a computer program that analyzes SEC filings, with supplemental data from Ives Group Audit Analytics.

domestic issuers are emerging growth companies,<sup>250</sup> and 42.5% are smaller reporting companies.<sup>251</sup>

The amendment related to the “look-back” period for assessing independence compliance will affect future domestic first-time filers, but not future FPI first-time filers. To assess the effects of this amendment, we utilized historical data for domestic IPOs. According to Thompson Reuters’ Security Data Company (“SDC”) database, there were approximately 543 domestic IPOs during the period between January 1, 2017, and December 31, 2019.

The amendment related to a transition framework for merger and acquisition transactions will affect issuers that might engage in mergers and acquisitions. To assess the overall market activity for mergers and acquisitions, we examined mergers and acquisitions data from SDC. During the period from January 1, 2017, to December 31, 2019, there were 6,057 mergers and acquisitions entered into by publicly listed U.S. firms.

The amendments to the ICC definition would potentially affect registered investment companies and unregistered funds.<sup>252</sup> As of September 2020, there were 2,763 registered

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<sup>250</sup> An “emerging growth company” is defined as an issuer that had total annual gross revenues of less than \$1.07 billion during its most recently completed fiscal year. *See* 17 CFR 230.405 and 17 CFR 240.12b-2. *See* Rule 405; Rule 12b-2; 15 U.S.C. 77b(a)(19); 15 U.S.C. 78c(a)(80); and Inflation Adjustments and Other Technical Amendments under Titles I and II of the JOBS Act, Release No. 33- 10332 (Mar. 31, 2017) [82 FR 17545 (Apr. 12, 2017)]. We based the estimate of the percentage of emerging growth companies on whether a registrant claimed emerging growth company status, as derived from Ives Group Audit Analytics data as of December 2019.

<sup>251</sup> “Smaller reporting company” is defined in 17 CFR 229.10(f) as an issuer that is not an investment company, an asset-backed issuer (as defined in 17 CFR 229.1101), or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: (i) had a public float of less than \$250 million; or (ii) had annual revenues of less than \$100 million and either: (A) no public float; or (B) a public float of less than \$700 million.

<sup>252</sup> Based on the current reporting requirements for unregistered funds, we do not have data readily available regarding unregistered funds that would allow us to quantify the number of unregistered funds that would be affected by the final amendments. We did not receive data regarding unregistered funds from commenters.



investment companies that filed annual reports on Form N-CEN. As of July 2020, there were 10,092 mutual funds (excluding money market funds) with \$19,528 billion in total net assets, 2,142 exchange traded funds (“ETFs”) organized as an open-end fund or as a share-class of an open-end fund with \$3,462 billion in total net assets, 666 registered closed-end funds with \$307 billion in total net assets, and 13 variable annuity separate accounts registered as management investment companies on Form N-3 with \$216 billion in total net assets. There also were 420 money market funds with \$3,881 billion in total net assets.<sup>253</sup> Also, as of July 2020, there were 99 business development companies (“BDCs”) with \$58 billion in total net assets.<sup>254</sup>

### **C. Potential Costs and Benefits**

#### **1. Overall Potential Costs and Benefits**

We anticipate the final amendments will benefit audit firms, audit clients, and investors in several ways. First, by revising our rules to emphasize those relationships and services that are more likely to threaten auditor objectivity and impartiality, the final amendments will reduce compliance costs for audit firms and their clients. Under the amended rules, auditors and their clients will be able to focus their resources and attention on monitoring those relationships and services that pose the greatest risk to auditor independence. This will reduce overall compliance burdens without significantly diminishing investor protections.

The final amendments also may enhance the audit process by expanding the pool of

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<sup>253</sup> Estimates of the number of registered investment companies and their total net assets are based on a staff analysis of Form N-CEN filings as of July 8, 2020. For open-end funds that have mutual fund and ETF share classes, which only one fund sponsor currently operates, we count each type of share class as a separate fund and use data from Morningstar to determine the amount of total net assets reported on Form N-CEN attributable to the ETF share class. As money market funds generally are excluded we report their number and net assets separately from those of other mutual funds.

<sup>254</sup> Estimates of the number of BDCs and their net assets are based on a staff analysis of Form 10-K and Form 10-Q filings as of July 30, 2020. Our estimate includes BDCs that may be delinquent or have filed extensions for their filings, and it excludes six wholly-owned subsidiaries of other BDCs.

eligible auditors. The potential larger pool of eligible auditors may allow audit clients to better align audit expertise with the needs of the audit engagement, which may lead to an improvement in audit quality and financial statement quality.<sup>255</sup> For example, audit clients in certain industries might have more complicated or very specialized businesses that would benefit from auditors with certain expertise or experience. If the pool of potential independent auditors is restricted due to provisions under current Rule 2-01 that are the subject of the final amendments, an audit client might have to choose a non-preferred audit firm, which may not provide the desired scope or quality of audit services. Because audit quality is correlated with financial reporting quality,<sup>256</sup> any improved financial reporting quality resulting from the final amendments will provide additional benefits by potentially reducing information asymmetry between issuers and their investors, improving firms' liquidity, and decreasing cost of capital.<sup>257</sup> Investors similarly will benefit from any resulting improvement in financial reporting quality.

With a larger pool of eligible auditors, audit clients could potentially avoid costs associated with searching for a new independent auditor and related costs resulting from switching from one audit firm to another, for example, when a new sister entity gives rise to an independence-impairing relationship for the entity under audit. A larger pool of potentially

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<sup>255</sup> See Mark DeFond and Jieying Zhang, A Review of Archival Auditing Research, 58 J. Acct. Econ. 275 (2014).

<sup>256</sup> See *id.*

<sup>257</sup> See Siew H. Teoh and T. J. Wong, Perceived Auditor Quality and the Earnings Response Coefficient, 68 Acct. Rev. (1993) 346-366. See also Jeffery A. Pittman and Steve Fortin, Auditor Choice and the Cost of Debt Capital for Newly Public Firms, 37 J. Acct. Econ. (2004). 113-136; Jere R. Francis and Bin Ke, Disclosure of Fees Paid to Auditors and the Market Valuation of Earnings Surprises, 11 Rev. Acct. Stud. (2006) 495-523; Chan Li, Yuan Xie, and Jian Zhou, National Level, City Level Auditor Industry Specialization and Cost of Debt, 24 Acct. Horizon (2010) 395-417; and Jagan Krishnan, Chan Li, and Qian Wang, Auditor Industry Expertise and Cost of Equity, 27 Acct. Horizon (2013) 667-691.

qualified independent auditors may promote competition among audit firms, which may lower audit fees for comparable audit quality. Reduction in audit fees would lead to cash savings for audit clients, who could further invest those savings or return those savings to investors, all of which may accrue to the benefit of investors. However, this competitive effect may be limited because the audit profession is highly concentrated<sup>258</sup> with the four largest audit firms auditing about 49.2% of all registrants.<sup>259</sup> More specifically, as noted above, the four largest audit firms audit about 73% of accelerated and large accelerated filers.<sup>260</sup>

Auditors also could benefit from potentially having a broader spectrum of audit clients and clients for non-audit services as a result of the final amendments. If the amendments reduce certain burdensome constraints on auditors in complying with the independence requirements, auditors likely will incur fewer compliance costs. For example, audit firms will not need to discontinue their non-audit services or switch their audit services as a result of certain client affiliations that are no longer deemed independence-impairing under the dual materiality thresholds. In addition, the final amendments potentially could reduce auditor turnover due to changes in audit clients' organizational structure arising from certain merger and acquisition activities. The final amendments also may benefit auditors that provide non-audit services, as those audit firms, under the final amendments, will be permitted to provide such services to a sister entity, so long as either the entity under audit or the sister entity is not material to the controlling entity. Similarly, under the final amendments, audit firms that currently provide non-

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<sup>258</sup> See United States Government Accountability Office. Audits of Public Companies – Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action, *available at* [www.gao.gov/new.items/d08163.pdf](http://www.gao.gov/new.items/d08163.pdf) (2008).

<sup>259</sup> See *supra* note 246.

<sup>260</sup> *Id.*

audit services will be able to provide auditing services to sister entities under common control as long as the dual materiality thresholds are not triggered.

There also could be certain costs associated with the final amendments. For example, if the amendments increase the risk of auditors' objectivity and impartiality being threatened by relationships and services that are no longer deemed independence-impairing, audit quality could be negatively affected and investors could have less confidence in the quality of financial reporting, which could lead to less efficient investment allocations and increased cost of capital. One commenter asserted that the final amendments would undermine the credibility of auditors, with harmful effects on investor protection and capital formation.<sup>261</sup> We note, however, that relationships and services impacted by the final amendments remain subject to the general independence standard in Rule 2-01(b). Additionally, auditors will incur ongoing costs associated with the monitoring of potential affiliate status if they elect to rely on the final amendments to realize the associated benefits (*e.g.*, the ability to retain or acquire new engagements that were previously deemed independence-impairing). Overall, however, we do not anticipate significant costs to investors or other market participants associated with the final amendments because the amendments address those relationships and services that are less likely to threaten auditors' objectivity and impartiality.

## **2. Costs and Benefits of Specific Amendments**

We expect the final amendments will result in benefits and costs to auditors, audit clients, and investors, and we discuss those benefits and costs qualitatively, item by item, in this section.

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<sup>261</sup> See letter from CFA.

**a. Amendments to the Definition of an Affiliate of the Audit Client and Investment Company Complex**

**i. Affiliate of the Audit Client**

The inclusion of all sister entities regardless of materiality in the definition of affiliate of the audit client in current Rule 2-01(f)(4) creates practical challenges and imposes compliance costs on both auditors and audit clients, especially those with complex organizational structures. As it relates to the common control provision, the proposed amendment included as affiliates of the audit client sister entities that are material to the controlling entity. As discussed in Section II.A.1.a, commenters recommended further aligning the common control provision with analogous provisions of the AICPA and IESBA ethics and independence requirements, and the final amendments now include a dual materiality threshold such that a sister entity would be deemed an affiliate of the audit client only when both the entity under audit and the sister entity are material to the controlling entity. Conditioning affiliate status on the entity under audit being material to the controlling entity, and excluding sister entities that are not material to the controlling entity, likely will reduce overall compliance burdens and challenges associated with having to resolve independence violations arising from services or relationships with sister entities. Two commenters argued that relying on materiality may increase the risk of auditors performing audits when they are not objective and impartial, citing evidence that auditors' materiality judgments vary widely.<sup>262</sup> While we acknowledge that the use of materiality introduces judgment compared to a bright-line test, we note that the evidence presented by these

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<sup>262</sup> See *supra* note 29.

commenters, on which their conclusion is based, is not directly related to materiality assessments in the context of sister entities.

As discussed in Section II.A.1.a.iii, monitoring-related compliance burdens may not be reduced. Under the current rules, an auditor needs to examine an audit client's organizational structure and identify all sister entities that will be considered affiliates on the basis of a bright-line standard. Under the final amendments, auditors, with the assistance of their audit clients, still need to understand an audit client's organizational structure to identify any affiliates of the audit client as well as monitor for changes in the structure and materiality status of those affiliates on an on-going basis.<sup>263</sup> Thus, auditors may incur some incremental cost related to monitoring potential affiliate status and assessing materiality. Auditors, however, would weigh whether the associated benefits (*e.g.*, the possibilities of offering new services or entering into new relationships) are worth the incremental materiality assessment and monitoring efforts. We expect an auditor would rely on the final amendments only if the benefits of using the amendments outweigh the costs involved. If an auditor decides it does not want to incur any increased monitoring-related compliance burdens, it could treat all sister entities as affiliates and avoid the effort to assess materiality.

The final amendments related to the dual materiality threshold should reduce the overall compliance related challenges associated with the existing rule. Under existing Rule 2-01(f)(4), all sister entities are deemed affiliates. Existing Rule 2-01(f)(4) creates compliance challenges that require the auditor's and the audit client's attention to resolve or that can restrict the choices of the auditor and the audit client, even when the violations or potential violations are with sister

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<sup>263</sup> As discussed in Section II.A.1.a.iii, identifying sister entities and monitoring for potential affiliate status will be important to timely address when a sister entity may become an affiliate and is important for an audit firm to appropriately consider and apply Rule 2-01(b).

entities that are less likely to affect an auditor's objectivity and impartiality. For example, the dual materiality threshold will help avoid the costs that audit clients could incur to switch auditors where an auditor provides services to or has an existing relationship with a newly acquired sister entity and either the entity under audit or sister entity is not material to the controlling entity. These cost savings could be especially pronounced for entities with complex organizational structures that have an expansive and constantly changing list of affiliates because the final amendments may significantly reduce the number of sister entities that are deemed affiliates of the audit client.

Under the current definition of affiliate of the audit client, an auditor with desired expertise may be excluded from a firm's audit engagement consideration because, for example, the auditor currently provides non-audit services to the firm's sister entity, even though neither that entity nor the firm under audit is material to the controlling entity. The exclusion of certain auditors from an audit engagement due to their relationships with or services provided to a sister entity, in this example, might lead to the audit engagement not being matched with the most qualified auditors. Such an outcome could compromise audit quality and decrease financial reporting quality, thereby imposing compliance costs on audit clients and reducing the quality of financial information investors receive. In addition, the lack of matching between auditor expertise and necessary audit procedures and considerations for a particular audit client might result in inefficiencies in the auditing processes, which likely increases the costs of audit services (*e.g.*, audit fees).

The amended definition of affiliate of the audit client may result in an expansion of the pool of qualified auditors. With an expanded pool of eligible auditors, competition among

auditors might increase, thereby reducing audit fees for audit clients.<sup>264</sup> However, because the market for auditing services is highly concentrated, such cost savings are likely to be limited. The expanded pool of qualified auditors also might improve matching between auditor expertise and necessary audit procedures and considerations for a particular audit client, thereby improving audit efficiency and reducing audit costs.<sup>265</sup> Furthermore, any improvement in matching would positively influence audit quality and financial reporting quality.<sup>266</sup>

The final amendments are likely to benefit investors indirectly. First, investors will benefit from any improvements in financial reporting quality that may be derived from improvements in audit quality, as discussed above.<sup>267</sup> Better financial reporting quality helps investors make more efficient investment decisions, thereby improving market efficiency. Second, the potential reduction in audit fees from possible increased competition among auditors and improved audit efficiency might generate cash savings to audit clients, which may be deployed in a manner that benefits investors. We acknowledge, however, that potentially this

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<sup>264</sup> See Paul K. Chaney, Debra C. Jeter, and Pamela E. Shaw, Client-Auditor Realignment and Restrictions on Auditor Solicitation, 72 *Acct. Rev.* (1997) 433. See also Emilie R. Feldman, A Basic Quantification of the Competitive Implications of the Demise of Arthur Andersen, 29 *R. Ind. Org.* (2006) 193; Michael Ettredge, Chan Li, and Susan Scholz, Audit Fees and Auditor Dismissals in the SOX Era, 21 *Acct Horizon* (2011) 371; Wieteke Numan and Marleen Willekens, An Empirical Test of Spatial Competition in the Audit Market, 20 *J. Acct Econ.* 450 (2012); and Joseph Gerakos and Chad Syverson, Competition in the Audit Market: Policy Implications, 53 *J. Acct Res.* 725 (2015).

<sup>265</sup> This could result in some crowding-out effect, as the four largest audit firms may be deemed to be independent from more clients under the final amendments, thereby crowding out smaller audit firms. However, we believe that better matching between auditor specialization and their clients and the reduction in unnecessary auditor turnovers could potentially prevent any decline in audit quality and in the long run may improve audit quality.

<sup>266</sup> See Chen-Lung Chin, and Hsin-Yi Chin, Reducing Restatements with Increased Industry Expertise, 26 *Cont. Acct. Res.*, (2009) 729; Michael Ettredge, James Heintz, Chan Li, and Susan Scholz, Auditor Realignment Accompanying Implementation of SOX 404 ICFR Reporting Requirements, 25 *Acct Horizon* (2011) 17; and Jacob Z. Haislip, Gary F Peters, and Vernon J Richardson, The Effect of Auditor IT Expertise on Internal Controls, 20 *Int. J. Acct. Inf. Sys.* 1 (2016).

<sup>267</sup> See *supra* note 255.



competitive effect will be limited given the concentrated nature of the audit profession, as explained above.

The final amendments also include a modification to use the term “entity under audit” in place of the term “audit client” within Rules 2-01(f)(4)(i) and (ii). As discussed in Section II.A.1.a.iii, these modifications are intended to address potential confusion that may result from an application that would negate the amendments to the common control provision. This clarification could assist audit firms and audit clients in their compliance with the independence requirements.

The dual materiality threshold in the amended definition of an affiliate of the audit client might require more efforts from audit firms and audit clients to familiarize themselves with and to apply the threshold. However, given that the materiality concept is already part of the Commission’s auditor independence rules,<sup>268</sup> and that the analogous provisions of the AICPA and IESBA for sister entities also include a dual materiality threshold, we do not expect a significant learning curve in applying the threshold or significant incremental compliance costs for auditors.

## **ii. Investment Company Complex**

As discussed in Section II.A.1.c above, the final amendments: (1) direct an auditor of an investment company or an investment adviser or sponsor to Rule 2-01(f)(14) (*i.e.*, the ICC definition) to identify affiliates of the audit client and focus the ICC definition on the perspective of the entity under audit; (2) include within the meaning of the term investment company, for the purposes of the ICC definition, unregistered funds; (3) amend the common control portion of the

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<sup>268</sup> See *e.g.*, Rule 2-01(f)(4)(ii) and (iii).

ICC definition to incorporate the dual materiality threshold included in the amended affiliate of the audit client definition; (4) add a dual materiality threshold in the control prong of the ICC definition, for portfolio companies of sister funds controlled by an investment adviser or sponsor of an investment company under audit; and (5) include within the ICC definition entities where significant influence exists between those entities and the entity under audit.

The amendments related to the ICC definition will affect the analysis used to identify entities that are considered affiliates of registered investment companies, unregistered funds, and investment advisers or sponsors that are under audit. The final rule should lead to improved clarity in the application of the ICC definition and, for the purpose of auditor independence analysis, could facilitate compliance by audit firms and the entities they audit within an ICC with the auditor independence requirements. The improved clarity under the amended definition may result in compliance cost savings that benefit audit firms and audit clients.

The economic implications of the amended common control provision within the ICC definition are largely similar to those of the analogous provision for operating companies. For example, under the current ICC definition, an investment company under audit may have a rather restricted set of independence compliant auditors due to the current common control provisions. The amended ICC definition excludes from the affiliate analysis sister entities when both the sister entities and the entity under audit are not material to the controlling entity, which potentially reduces compliance costs for an investment company under audit.

Auditors currently engaging in relationships with or providing services to entities within an ICC that are independence-impairing under Rule 2-01(c) may become eligible to serve as an auditor to a different entity within the same ICC under the amended definition, including the amended common control provision. The potential expanded pool of eligible auditors could help

registered investment companies and unregistered funds hire (and retain) auditors who have more relevant industry expertise, which could lead to better financial reporting for investment companies. Better financial reporting quality, in turn, would benefit investors in registered investment companies and unregistered funds by allowing them to make more informed investment decisions. With an expanded pool of eligible auditors, competition among auditors might increase, thereby reducing audit fees for audit clients for comparable audit quality, though potentially this competitive effect will be limited given the market concentration discussed above.

With respect to the amendments that include unregistered funds within the meaning of the term investment company for purposes of the ICC definition,<sup>269</sup> we believe the amendments provide a useful update to the ICC definition that was initially adopted in 2000. Specifically, we believe the final amendments provide clarity for unregistered funds, their investment advisers or sponsors, and their auditors. In addition, defining an investment company to include unregistered funds will promote consistency in the application of Rule 2-01 to registered investment companies and unregistered funds so that these two types of audit clients, which share some similar characteristics, will not be subject to disparate application of the independence rules.

We do not anticipate significant incremental costs associated with the final amendments to the ICC definition for registered investment companies, unregistered funds, investment advisers or sponsors, or their auditors as well as investment company investors. The amendments may require additional efforts from audit firms and the entities they audit within an

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<sup>269</sup> See amended Rule 2-01(f)(14)(ii).

ICC to become familiar with the application of the amended ICC definition. This may potentially lead to an initial increase in compliance costs. However, the amendments would improve the clarity of the ICC definition and therefore likely would decrease overall compliance costs after affected parties adjust to the amended definition.

The materiality test that we are adopting is already part of the Commission’s auditor independence rules<sup>270</sup> and also is aligned with the final common control prong of the affiliate of the audit client definition. Consistent with our discussion in the preceding section, we do not expect a significant learning curve in applying the dual materiality threshold or significant incremental compliance costs for auditors or their audit clients.

As with auditors of operating companies, auditors of investment companies or investment advisers or sponsors will be required to consider significant influence when identifying affiliates of the audit client. We do not expect any significant economic effects associated with adding the “significant influence” provision<sup>271</sup> to the amended ICC definition. As discussed in Section II.A.1.c.iii above, audit clients and auditors should already be familiar with this concept as a result of the application of existing Rule 2-01(f)(4)(ii) and (iii).

#### **b. Amendment to the Definition of Audit and Professional Engagement Period**

Currently, the term “audit and professional engagement period” is defined differently for domestic first-time filers and FPI first-time filers.<sup>272</sup> A domestic IPO registration statement must include either two or three years of audited financial statements, and auditors of domestic first -

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<sup>270</sup> See e.g., Rules 2-01(f)(4)(ii) and (iii).

<sup>271</sup> See amended Rule 2-01(f)(14)(i)(E).

<sup>272</sup> See Rule 2-01(f)(5)(iii).

time filers need to comply with Rule 2-01 for all audited financial statement periods included in the registration statement.<sup>273</sup> This may result in certain inefficiencies in the IPO process for domestic filers, such as the need to delay the offering or switch to a different auditor to comply with independence requirements. In comparison, for FPIs, the corresponding “audit and professional engagement period” includes only the fiscal year immediately preceding the initial filing of the registration statement or report. As a consequence, the current definition of the “audit and professional engagement period” creates disparate application of the independence requirements between domestic issuers and FPIs. To address this disparate treatment, we are amending the definition such that the one-year look-back provision applies to all first-time filers, domestic and foreign.

The final amendment to the definition of “audit and professional engagement period” will require domestic first-time filers to assess auditor independence over a shortened look-back period (*i.e.*, a single immediate preceding year). As a result, this amendment could help domestic firms avoid the compliance costs associated with switching auditors or delaying the filing of an initial registration statement when there is an independence-impairing relationship or service in earlier years. In this way, shortening the look-back period may promote efficiency and facilitate capital formation.

This amendment might also expand the pool of eligible auditors for domestic first-time filers. The potential increase in the number of eligible auditors for these filers could foster competition among eligible auditors and thus reduce the cost of audit services.<sup>274</sup> Specifically, where an audit client is looking to change auditors in connection with an IPO, an audit client

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<sup>273</sup> See Rule 2-01(f)(5).

<sup>274</sup> See *supra* note 264.

would be able to select from a broader group of auditors to perform audit services, even if there were independence-impairing services or relationships in the second or third year prior to the filing of the initial registration statement. However, the audit profession is already highly concentrated, especially with respect to IPOs.<sup>275</sup> Consequently, any such benefit may not be significant. The expanded pool of qualified auditors also could allow the first-time domestic filers to better match auditor expertise to audit engagements. We anticipate that the improved alignment between auditor expertise and audit engagement likely will positively influence audit and financial reporting quality, thereby benefiting investors and improving market efficiency.<sup>276</sup>

The change in the look-back period for domestic first-time filers might lead to some financial statements in early years being audited by auditors that do not meet the Commission's current independence requirements, thus potentially compromising the integrity and reliability of financial reporting information related to the earlier second and third years, if included in the first filing. However, this potential adverse effect would be mitigated by the requirement for these auditors to meet applicable independence requirements—such as AICPA independence requirements—for the audits of these periods and by the application of the general independence standard in Rule 2-01(b) to the relationships and services in those earlier years. In addition, there are often, if not always, internal and external governance mechanisms (*e.g.*, audit committees and underwriters) in place at first-time filers, and auditors are subject to heightened litigation risk

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<sup>275</sup> See United State Government Accountability Office, Audits of Public Companies – Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action (2008) available at [www.gao.gov/new.items/d08163.pdf](http://www.gao.gov/new.items/d08163.pdf). See also Patrick Velte and Markus Stiglbauer, Audit Market Concentration and Its Influence on Audit Quality, 5 Intl. Bus. Res. (2012) 146; and Xiaotao Liu and Biyu Wu, Do IPO Firms Misclassify Expenses? Working paper, (2019) (showing that 84.2% of IPO firms of their sample use Big 4 auditors before going public).

<sup>276</sup> See *supra* note 255 and accompanying text.

around IPOs.<sup>277</sup>

### **c. Amendments to Loans or Debtor-Creditor Relationships**

Currently, Rule 2-01 prohibits certain loans/debtor-creditor relationships and other financial interests with a few exceptions.<sup>278</sup> As discussed in Sections II.B.1 and 3, the final amendments will address two types of loans that are less likely to threaten an auditor's objectivity and impartiality by making the following changes: (1) include, as part of the exceptions, student loans for a covered person and his/her immediate family members as long as the loan was obtained while the covered person was not a covered person; and (2) amend the Credit Card Rule to refer instead to "consumer loans" in order to except personal consumption loans such as retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence.

The amendments to except certain student and consumer loans that are less likely to pose threats to auditors' objectivity or impartiality may alleviate some compliance burdens. For instance, audit firms will be able to reduce the level of monitoring for such student and consumer loans as part of their compliance program. The amendments would permit certain covered persons (including audit partners and staff) to be considered independent even when covered persons or their immediate family members have student loans or consumer loans with an audit client. The potential expansion of qualified audit partners and staff may allow audit firms to more readily identify audit partners and staff for a given audit engagement and improve matching between partner and staff experience with audit engagements. The improved

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<sup>277</sup> See Ray Ball and Lakshmana Shivakumar, Earnings Quality at Initial Public Offerings, 45, J. Acct. Econ. (2008) 324-349. See also Ramgopal Venkataraman, Joseph P. Weber and Michael Willenborg, Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings, 83 Acct Rev. (2008) 1315-1345.

<sup>278</sup> See Rule 2-01(c)(1)(ii).

alignment between partner and staff experience and audit engagements can increase audit efficiency and reduce audit costs. Such efficiency gains may transfer to audit clients in the form of reduced audit fees and audit delays.

Moreover, the better alignment between partner and staff experience and audit engagement may increase audit quality.<sup>279</sup> Since audit quality improvement increases financial reporting quality, this benefit likely will accrue to the overall investment community.<sup>280</sup> Finally, the final amendments may make it easier for covered persons and their immediate family members to obtain necessary consumer loans without having to determine if such loans are with audit clients of the accounting firm.

#### **d. Amendments to the Business Relationships Rule**

As discussed in Section II.C, the Business Relationships Rule currently refers to “substantial stockholders” to identify a type of “person associated with the audit client in a decision-making capacity.”<sup>281</sup> Under the current rule, a business relationship between a substantial stockholder of the audit client, among others, and the auditor or covered person would be considered independence-impairing. The final amendment will change the term “substantial stockholders” to “beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the entity under audit” to align this rule with changes recently made to the Loan Provision.<sup>282</sup> In a

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<sup>279</sup> See e.g., G. Bradley Bennett & Richard C. Hatfield, The Effect of the Social Mismatch between Staff Auditors and Client Management on the Collection of Audit Evidence, 88 Acct. Rev. (2013) 31-50.

<sup>280</sup> See *supra* note 255 and accompanying text.

<sup>281</sup> See Rule 2-01(c)(3).

<sup>282</sup> See Section II.C.4.



modification from the proposal, the final rule now codifies the guidance provided in the Proposing Release, which clarified that “significant influence over the audit client” is meant to focus on the entity under audit. Also, the final amendment clarifies that with respect to other persons in a decision-making capacity, such as officers and directors, the focus is similarly meant to be on the entity under audit. This amendment should improve compliance with the auditor independence rules by improving the clarity and reducing the complexity of application of the Business Relationships Rule.

There may be some additional compliance costs to auditors and audit clients associated with having to comply with a standard that now requires identifying beneficial owners of equity securities that have “significant influence” over the audit client, as opposed to identifying “substantial stockholders.” However, any such additional cost should be limited given that the concept of “significant influence” has been part of the Commission’s auditor independence rules since 2000 as part of the definition of affiliate of the audit client.<sup>283</sup> We therefore do not expect a significant learning curve in applying the test for auditors and registrants.

#### **e. Amendments for Inadvertent Violations for Mergers and Acquisitions**

As discussed in Section II.D, certain merger and acquisition transactions can give rise to inadvertent violations of auditor independence requirements. For example, an auditor may provide non-audit services to a target firm and audit services to an acquirer prior to the occurrence of an acquisition. As a result, the acquisition may result in an auditor independence violation that had not existed prior to the acquisition. In this scenario, the auditor’s objectivity and impartiality likely is not impaired.<sup>284</sup>

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<sup>283</sup> See e.g., Rule 2-01(f)(4)(ii) and (iii).

<sup>284</sup> See Section II.D.

There may be compliance costs associated with the application of the current rule in that registrants might have to: (i) delay mergers and acquisitions in order to comply with Rule 2-01; (ii) forgo such transactions altogether; or (iii) switch auditors or stop the relationships or services mid-stream, potentially resulting in costly disruptions to the registrant.

As discussed in Section II.D.3, the final amendments to Rule 2-01(e) establish a transition framework for mergers and acquisitions to address these costs. Under the amendments, auditors and their audit clients will be able to transition out of independence-impairing relationships or services in an orderly manner, subject to certain conditions. As such, the amendments likely will reduce audit clients' compliance costs in merger and acquisition transactions by reducing the uncertainty associated with incidences of inadvertent violations of auditor independence due to these corporate events.

For example, the transition framework will allow auditors and audit clients, subject to certain conditions, up to six months after the transaction effective date to terminate the independence-impairing relationships or services. As a result, this framework will help audit clients, especially those entities with complex organizational structures and those actively pursuing merger and acquisition transactions, retain an auditor that is compliant with the auditor independence requirements when they undertake mergers and acquisitions without missing out on the ideal timing for such transactions. In addition, investors may indirectly benefit from the value created through timely mergers and acquisitions and costs saved from managing inadvertent independence violations.

There may be some learning curve for auditors and audit clients as they adapt to the transition framework. However, given that the framework follows the consideration of the audit firm's quality controls similar to existing Rule 2-01(d), we do not expect a significant learning

curve in applying the framework for auditors and audit clients. The framework does not alter the independence requirements for entities involved in mergers and acquisitions *per se*; rather, the framework offers a more practical approach to, and timeline for, addressing inadvertent independence violations as a result of merger and acquisition transactions. Thus, we do not anticipate significant compliance costs associated with this amendment.

#### **D. Effects on Efficiency, Competition and Capital Formation**

We believe that the final amendments likely will improve the practical application of Rule 2-01, enhance efficiency of rule implementation, reduce compliance burdens, and increase competition among auditors. They also may facilitate capital formation.

One commenter questioned our conclusion and argued that the final amendments would undermine the credibility of auditors and have harmful effects on capital formation.<sup>285</sup> We disagree with the commenter's assessment. The final amendments to Rule 2-01 aim to reduce or remove certain practical challenges associated with the auditor independence analysis by focusing the analysis on those relationships and services that are more likely to pose a threat to an auditor's objectivity and impartiality. The amendments are expected to expand the pool of auditors and covered persons eligible to undertake audit engagements. As a result, audit clients should have more options for audit services and audit costs may decrease for comparable audit quality. The potential expansion of eligible auditors may also lead to better alignment between the audit client's needs and the auditor's expertise. The improved alignment between auditor expertise and audit client needs should enable auditors to perform audit services more efficiently and effectively, thus potentially reducing audit fees and increasing audit quality over the long term.

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<sup>285</sup> See letter from CFA.

Under the final amendments, certain relationships and services between an auditor and an audit client that are currently deemed independence-impairing but are unlikely to threaten auditor objectivity and impartiality will no longer be deemed independence-impairing (subject to the general independence standard in Rule 2-01(b)), thus allowing auditors and audit clients to focus on those relationships and services that are more likely to threaten the auditor's objectivity and impartiality. To the extent that the amendments may reduce the amount of audit client or audit committee attention spent on independence questions when objectivity and impartiality is not at issue, the quality of financial reporting is likely to improve, thus allowing audit committees to focus on their other responsibilities. Furthermore, we expect that improved identification of threats to auditor independence would increase investor confidence about the quality and accuracy of the information reported. Reduced uncertainty about the quality and accuracy of financial reporting should attract capital and thus reduce the cost of capital, facilitate capital formation, and improve overall market efficiency.<sup>286</sup>

Under the final amendments, we expect some accounting firms to become eligible to provide audit services to new audit clients that were previously deemed independence-impairing under existing Rule 2-01. If the larger accounting firms are currently engaged in non-audit relationships with and providing services to potential audit clients that preclude such accounting firms from serving as the auditor under existing Rule 2-01, then these firms are more likely to be positively affected by the final amendments. In particular, these accounting firms may be able to compete for or retain a larger pool of audit clients. At the same time, the larger accounting

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<sup>286</sup> See *supra* note 255. See also Nilabhra Bhattacharya, Frank Ecker, Per Olsson, and Katherine Schipper, Direct and Mediated Associations among Earnings Quality, Information Asymmetry and the Cost of Equity, 87, *Acct Rev.* (2012) 449-482; and Shuai Ma, Economic Links and the Spillover Effect of Earnings Quality on Market Risk. 92 *Acct Rev.* (2017). 213-245.

firms' potentially increased ability to compete for audit clients could potentially crowd out the audit business of smaller audit firms. However, we estimate that the four largest accounting firms already perform 49.2% of audits for all registrants (or about 73% of accelerated and large accelerated filers) and more than 80% in the registered investment company space.<sup>287</sup> As a result, we do not expect any potential change in the competitive dynamics among accounting firms to be significant.

#### **E. Alternatives**

We considered certain alternative approaches to the final amendments, which we summarize below.

As an alternative to the dual materiality threshold for the definition of affiliate of the audit client that we are adopting, we could have adopted the single materiality threshold that was proposed in the Proposing Release. Under such an alternative, a sister entity would be deemed an affiliate of the audit client unless the entity is not material to the controlling entity, and there would be no materiality qualifier with respect to the entity under audit. Such an alternative, however, would introduce costs for both auditors and audit clients' sister entities relative to the final amendments when the entity under audit is not material to the controlling entity. For example, an auditor would not be allowed to provide certain services to sister entities even though its services with those entities would generally not threaten the auditor's objectivity and impartiality. One commenter argued that such an alternative would increase the burden on private equity firms by requiring more time and resources to monitor the "continuously evolving

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<sup>287</sup> See *supra* note 246. Also, as of December 2018, there were approximately 12,577 fund series, with total net assets of \$23 trillion that are covered by Morningstar Direct with identified accounting firms. There were 23 accounting firms performing audits for these investment companies. The market for these audit services was highly concentrated, as 86% of the funds were audited by the four largest accounting firms.

universe of entities that the private firm would need to address.”<sup>288</sup>

An alternative approach to the amendments to the definition of “audit and professional engagement period” would be to increase the look-back period for FPI first-time filers to align with the current requirement for domestic first-time filers. While this alternative would help level the playing field for both domestic and FPI first-time filers, similar to the final amendment to shorten the look-back period for a first-time domestic filer, and reduce the likelihood of potential independence-impairing relationships and services, it would increase compliance burdens for FPI first-time issuers and thus may reduce the incentives for the FPI first-time filers to list in the United States, thereby impeding capital formation and limiting investment opportunities for U.S. investors. As discussed above, we believe services or relationships that ended prior to the start of the most recently completed fiscal year are less likely to threaten an auditor’s objectivity and impartiality. We do not, therefore, believe that lengthening the look-back period for FPIs would enhance investor protection in a manner that would justify an associated increase in compliance costs and a potential negative impact on capital formation.

An alternative to the complete exclusion of student loans of the covered person would be a bright-line test in which, if the percentage of the aggregate amount of the student loans of a covered person and his or her immediate family members to the total wealth of the covered person’s family is below a certain threshold, then all of the students loans would be excluded from the prohibition. This alternative has the advantage of taking into consideration the importance of the student loans to the covered person’s financial interests. However, this alternative, because it is a bright-line test, may lead to over-identifying or under-identifying scenarios where the auditor’s objectivity and impartiality are deemed impaired, especially in

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<sup>288</sup> See letter from AIC.

cases close to the selected percentage threshold. In addition, this alternative could present operational and privacy challenges in calculating and monitoring changes to a family's total wealth.

An alternative with respect to the exclusion for consumer loans would be to increase the outstanding balance limit, currently set at \$10,000. For example, several commenters suggested inflationary adjustments to the outstanding balance limit to make it as high as \$20,000 or \$25,000.<sup>289</sup> Such an increase would make it easier for covered persons to meet the requirements of the rule, and thus benefit audit clients by making it easier for them to find an auditor. Such an alternative, however, also would allow a covered person to have a significant amount of outstanding consumer loan(s) with an audit client, increasing the risk to the auditor's objectivity and impartiality and potentially negatively affecting investor protection.

Finally, the transition framework for merger and acquisition transactions includes a provision that, subject to certain conditions, allows affected auditors and audit clients to address independence-impairing relationships or services promptly, but in no event more than six months, following the effective date of the transaction. An alternative approach would be to require the independence-impairing relationship or service to be addressed within six months following the merger or acquisition announcement. A benefit of this alternative approach would be the improved timeliness of auditor compliance following merger and acquisition transactions. Under this alternative, auditors and registrants would assess independence immediately following the announcement that a definite agreement has been reached. However, some mergers and acquisitions take a long time to be completed and a substantial portion of such

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<sup>289</sup> See e.g., letters from BDO, EY, Horahan, CAQ, PwC, and RSM.

transactions never reach completion. As a result, an alternative window of six months following announcement of the merger or acquisition may unnecessarily increase compliance burdens and associated costs (*e.g.*, switching costs) for both affected companies and their auditors when such transactions are delayed or never successfully completed. A commenter suggested another alternative with respect to merger and acquisition transactions: to require the relationship or service triggering the inadvertent violation to be terminated before the merger or acquisition is effective.<sup>290</sup> Requiring termination prior to the merger and acquisition transaction, however, would generate significant costs for the auditor and the audit client, including search costs for finding a new auditor and disruption to valuable relationships and services for the company.

## **V. PAPERWORK REDUCTION ACT**

The final amendments do not impose any new “collections of information” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”),<sup>291</sup> nor do they create any new filing, reporting, recordkeeping, or disclosure requirements. Accordingly, we are not submitting the final amendments to the Office of Management and Budget for review in accordance with the PRA.<sup>292</sup> In the Proposing Release, the Commission asked about the conclusion that the amendments would not impose any new collections of information. We did not receive any comments in response.

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<sup>290</sup> See letter from NYSSCPA.

<sup>291</sup> 44 U.S.C. 3501 *et seq.*

<sup>292</sup> 44 U.S.C. 3507(d) and 5 CFR 1320.11.



## VI. FINAL REGULATORY FLEXIBILITY ACT ANALYSIS

The Regulatory Flexibility Act (“RFA”)<sup>293</sup> requires the Commission, in promulgating rules under section 553 of the Administrative Procedure Act,<sup>294</sup> to consider the impact of those rules on small entities. We have prepared this Final Regulatory Flexibility Analysis (“FRFA”) in accordance with Section 604 of the RFA.<sup>295</sup> This FRFA relates to final amendments to Rule 2-01 of Regulation S-X. An Initial Regulatory Flexibility Analysis (“IRFA”) was prepared in accordance with the RFA and was included in the Proposing Release.

### A. Need for, and Objectives of, the Final Amendments

As discussed above, the primary reason for, and objective of, the final amendments is to update certain provisions within the Commission’s auditor independence requirements to more effectively focus the analysis under Rule 2-01 on those relationships or services that are more likely to pose threats to an auditor’s objectivity and impartiality. Specifically, the final amendments:

- Amend the definitions of affiliate of the audit client and ICC to address certain affiliate relationships;
- Shorten the look-back period for domestic first-time filers in assessing compliance with the independence requirements;
- Add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships;
- Replace the reference to “substantial stockholders” in the Business Relationships

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<sup>293</sup> 5 U.S.C. 601 *et seq.*

<sup>294</sup> 5 U.S.C. 553.

<sup>295</sup> 5 U.S.C. 604.

Rule with the concept of beneficial owners with significant influence;

- Introduce a transition framework for merger and acquisition transactions to consider whether an auditor's independence is impaired; and
- Make certain other miscellaneous updates.

The reasons for, and objectives of, the final amendments are discussed in more detail in Sections I and II above.

### **B. Significant Issues Raised by Public Comment**

In the Proposing Release, we requested comments on the IRFA. In particular, we requested comments on the number of small entities that would be subject to the proposed amendments to Rule 2-01 of Regulation S-X and the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis. In addition, we requested comments regarding how to quantify the impact of the proposed amendments and alternatives that would accomplish our stated objectives while minimizing any significant adverse impact on small entities. We also requested that commenters describe the nature of any effects on small entities subject to the proposed amendments to Rule 2-01 of Regulation S-X and provide empirical data to support the nature and extent of such effects. Furthermore, we requested comment on the number of accounting firms with revenue under \$20.5 million. We did not receive comments regarding the impact of the proposal on small entities.

### **C. Small Entities Subject to the Proposed Rules**

The final amendments will affect small entities that file registration statements under the Securities Act, the Exchange Act, and the Investment Company Act and periodic reports, proxy and information statements, or other reports under the Exchange Act or the Investment Company Act, as well as smaller registered investment advisers and smaller accounting firms. The RFA

defines “small entity” to mean “small business,” “small organization,” or “small governmental jurisdiction.”<sup>296</sup> The Commission's rules define “small business” and “small organization” for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Title 17 CFR 230.157 and 17 CFR 240.0-10(a) define an issuer, other than an investment company, to be a “small business” or “small organization” if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that, as of December 31, 2019, there are approximately 1,056 issuers, other than registered investment companies, that may be small entities subject to the final amendments.<sup>297</sup> The final amendments will affect small entities that have a class of securities that are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. In addition, the final amendments will affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn.

An investment company is considered to be a “small business” for purposes of the RFA, if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less at the end of the most recent fiscal year.<sup>298</sup> We estimate that, as of June 2020, approximately 39 registered open-end mutual funds, 8 registered ETFs, 26 registered closed-end funds, and 12 BDCs are small entities.<sup>299</sup>

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<sup>296</sup> 5 U.S.C. 601(6).

<sup>297</sup> This estimate is based on staff analysis of issuers, excluding co-registrants, with EDGAR filings on Forms 10-K, 20-F and 40-F, or amendments thereto, filed during the calendar year of January 1, 2019, to December 31, 2019. The analysis is based on data from XBRL filings, Compustat, and Ives Group Audit Analytics.

<sup>298</sup> 17 CFR 270.0-10(a).

<sup>299</sup> This estimate is based on staff analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending June 30, 2020.

For purposes of the RFA, an investment adviser is a small entity if it:

- (1) Has assets under management having a total value of less than \$25 million;
- (2) Did not have total assets of \$5 million or more on the last day of the most recent fiscal year; and
- (3) Does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had total assets of \$5 million or more on the last day of its most recent fiscal year.<sup>300</sup>

We estimate, as of June 30, 2020, that there are approximately 524 investment advisers that would be subject to the final amendments that may be considered small entities.<sup>301</sup>

For purposes of the RFA, a broker-dealer is considered to be a “small business” if its total capital (net worth plus subordinated liabilities) is less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to 17 CFR 240.17a-5(d) under the Exchange Act, or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and that is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>302</sup> As of June 30, 2020, we estimate that there are approximately 852 small entity

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<sup>300</sup> 17 CFR 275.0-7.

<sup>301</sup> This estimate is based on SEC registered investment adviser responses to Item 12 of Form ADV.

<sup>302</sup> 17 CFR 240.0-10(c).

broker-dealers that will be subject to the final amendments.<sup>303</sup>

Our rules do not define “small business” or “small organization” for purposes of accounting firms. The Small Business Administration (SBA) defines “small business,” for purposes of accounting firms, as those with under \$20.5 million in annual revenues.<sup>304</sup> We have limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than \$20.5 million in annual revenues. As noted in the preceding section, we also did not receive any data from commenters that would enable us to make such an estimate.

#### **D. Projected Reporting, Recordkeeping and Other Compliance Requirements**

The final amendments will not impose any reporting, recordkeeping, or disclosure requirements. The final amendments will impose new compliance requirements with respect to Rule 2-01.

With respect to the final amendments related to student loans, consumer loans, and the definition of the audit and engagement period for first-time filers, we believe these amendments are less burdensome than the current requirements and will not increase costs for smaller entities, including smaller accounting firms. With respect to the final amendments to the definitions of affiliate of the audit client and ICC, these amendments will reduce the number of entities that are deemed affiliates of the audit client. As such, any additional compliance effort related to the revised definitions (such as the need to monitor the materiality of entities under common control) will be offset by the less burdensome nature of the amended definitions as compared to the

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<sup>303</sup> This estimate is based on staff analysis of the most recent information available, as provided in Form X-17A-5 Financial and Operational Combined Uniform Single Reports filed pursuant to Section 17 of the Exchange Act and Rule 17a-5 thereunder.

<sup>304</sup> 13 CFR 121.201 and North American Industry Classification System (NAICS) code 541211. The SBA calculates “annual receipts” as all revenue. *See* 13 CFR 121.104.

current definitions.

With respect to the final amendment adding a merger and acquisition transition framework, small entities, including smaller accounting firms, will incur a new compliance burden only if an auditor and its client seek to avail themselves of the framework. As such, any additional compliance effort will be offset in any circumstance where relationships and services prohibited under the current rule will be deemed not to impair independence under the final amendments. Overall, the adopted transition framework provides a more practical approach to, and timeline for, addressing inadvertent independence violations that arise solely due to merger or acquisition transactions and reduces some of the cost associated with such inadvertent violations.

Regarding the final amendment to the Business Relationships Rule to replace the reference to “substantial stockholders” with the concept of beneficial owners with significant influence, the concept of “significant influence” already exists in other parts of the auditor independence rules, including the recently amended Loan Provision.<sup>305</sup> As such, we believe that affected entities will likely be able to leverage existing practices, processes, or controls to comply with the final amendments compared to having separate compliance requirements by retaining the reference to the substantial stockholder.

Compliance with the final amendments will require the use of professional skills, including accounting and legal skills. The final amendments are discussed in detail in Section II above. We discuss the economic impact, including the estimated costs, of the final amendments in Section III (Economic Analysis) above.

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<sup>305</sup> See Loan Provision Adopting Release.

## **E. Agency Action to Minimize Effect on Small Entities**

The RFA directs us to consider alternatives that would accomplish our stated objectives while minimizing any significant adverse impacts on small entities. Accordingly, we considered the following alternatives:

- Establishing different compliance or reporting requirements that take into account the resources available to small entities;
- Clarifying, consolidating, or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

In connection with the final amendments to Rule 2-01, we do not think it feasible or appropriate to establish different compliance or reporting requirements or timetables for small entities. The final amendments are designed to address compliance challenges for both large and small audit clients and audit firms, including smaller accounting firms. With respect to clarification, consolidation, or simplification of compliance and reporting requirements for small entities, the final amendments do not contain any new reporting requirements.

Some of the final amendments, such as establishing a dual materiality threshold for the common control provision in the affiliate of the audit client definition, amending the ICC definition, and incorporating the concept of “significant influence” into the Business Relationships Rule, will create new compliance requirements. However, the amendments to the affiliate of the audit client and the ICC definitions are less burdensome in nature when compared to the existing rules, and the amendment to the Business Relationships Rule will help with compliance by using a consistent concept that is defined and understood. These amendments are

meant to better identify those relationships and services that are more likely to impair an auditor's objectivity and impartiality, thereby resulting in fewer instances where certain relationships and services would cause the auditor to violate our independence requirements, as compared to the existing rule. The flexibility that could result from the final amendments will be applicable to all affected entities, regardless of size.

With respect to using performance rather than design standards, we note that several of the final amendments are more akin to performance standards. Rather than prescribe the specific steps necessary to apply such standards, the final amendments recognize that "materiality" and "significant influence" can be implemented using reasonable judgment to achieve the intended result. Regarding the mergers and acquisitions transition framework, the final amendments do not prescribe specific procedures or processes and instead focus on requiring the performance that would lead to the identification of potential violations and how to address such violations. We believe that the use of these standards will accommodate entities of various sizes while potentially avoiding overly burdensome methods that may be ill-suited or unnecessary given the facts and circumstances.

The final amendments are intended to update the independence rules to reflect recent feedback received from the public and the Commission's experience administering those rules since their adoption nearly two decades ago and address certain compliance challenges for audit firms and their clients, including those that are small entities. Overall, the final amendments are expected to be less burdensome in nature than the existing rule. For this reason, exempting small entities from the final amendments would increase, rather than decrease, their regulatory burden relative to larger entities. The potential benefits to be derived from the final amendments discussed in the Economic Analysis apply to small entities as well as the larger entities. As such,



exempting small entities from any of the final amendments would deprive them of the intended benefits and create the potential for confusion maintaining two sets of independence requirements.

## **VII. CODIFICATION UPDATE**

The “Codification of Financial Reporting Policies” announced in Financial Reporting Release No. 1<sup>306</sup> (April 15, 1982) is updated by adding at the end of Section 602, under the Financial Reporting Release Number (FR-85) assigned to this final release, the text in Sections I and II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

## **VIII. STATUTORY BASIS**

The amendments described in this release are being adopted under the authority set forth in Schedule A and Sections 7, 8, 10, and 19 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, and 23 of the Exchange Act, Sections 8, 30, 31, and 38 of the Investment Company Act of 1940, Sections 203 and 211 of the Investment Advisers Act of 1940, and Section 3(a) of the Sarbanes Oxley Act of 2002.

### **List of Subjects in 17 CFR Part 210**

Accountants, Accounting, Banks, Banking, Employee benefit plans, Holding companies, Insurance companies, Investment companies, Oil and gas exploration, Reporting and recordkeeping requirements, Securities, Utilities.

In accordance with the foregoing, the Commission amends title 17, chapter II of the Code

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<sup>306</sup> 47 FR 21028 (May 17, 1982).

of Federal Regulations as follows:

**PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975**

1. The authority citation for part 210 continues to read as follows:

*Authority:* 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, and sec. 102(c), Pub. L. 112-106, 126 Stat. 310 (2012), unless otherwise noted.

2. Amend § 210.2-01 by
  - a. Removing Preliminary Note to §210.2-01;
  - b. Adding an introductory paragraph;
  - c. Revising paragraph (c)(1)(ii)(A)(I)(iii);
  - d. Revising paragraph (c)(1)(ii)(A)(I)(iv);
  - e. Adding paragraph (c)(1)(ii)(A)(I)(v);
  - f. Revising paragraph (c)(1)(ii)(E);
  - g. Revising paragraph (c)(2)(iii)(B)(2)(i);
  - h. Revising paragraph (c)(2)(iii)(C)(3)(i);
  - i. Revising paragraph (c)(3);
  - j. Revising paragraph (c)(6)(i)(A)(I);
  - k. Revising paragraph (c)(6)(i)(B)(I);
  - l. Revising paragraph (e);

- m. Revising paragraph (f)(4);
- n. Revising paragraph (f)(5)(iii);
- o. Revising paragraph (f)(6); and
- p. Revising paragraph (f)(14).

The revisions and additions read as follows:

**§ 210.2-01 Qualifications of accountants.**

Section 210.2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client. Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) of this section reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in §210.2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client. These factors are general guidance only, and their application may depend on particular facts and circumstances. For that reason, §210.2-01(b) provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering

into relationships, including relationships involving the provision of services that are not explicitly described in the rule.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(A) *Loans/debtor-creditor relationship.* (I) Any loan (including any margin loan) to or from an audit client, an audit client's officers or directors that have the ability to affect decision-making at the entity under audit, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit. The following loans obtained from a financial institution under its normal lending procedures, terms, and requirements are excepted from this paragraph (c)(1)(ii)(A)(I):

\* \* \* \* \*

(iii) Loans fully collateralized by cash deposits at the same financial institution;

(iv) Mortgage loans collateralized by the borrower's primary residence provided the loans were not obtained while the covered person in the firm was a covered person; and

(v) Student loans provided the loans were not obtained while the covered person in the firm was a covered person.

\* \* \* \* \*

(E) *Consumer loans.* Any aggregate outstanding 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 any available grace period.

\* \* \* \* \*

(2) \* \* \*

(iii) \* \* \*

(B) \* \* \*

(2) \* \* \*

(i) Persons, other than the lead partner and the Engagement Quality Reviewer, who provided 10 or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(B)(1) of this section;

\* \* \* \* \*

(C) \* \* \*

(3) \* \* \*

(i) Persons, other than the lead partner and the Engagement Quality Reviewer, who provided 10 or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(C)(2) of this section;

\* \* \* \* \*

(3) *Business relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers or directors that have the ability to affect decision-making at the entity under audit or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit. The relationships described in this paragraph (c)(3) do not include a relationship in which the accounting firm or

covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

\* \* \* \* \*

(6) \* \* \*

(i) \* \* \*

(A) \* \* \*

(I) The services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or Engagement Quality Reviewer, as defined in paragraph (f)(7)(ii)(B) of this section; for more than five consecutive years; or

\* \* \* \* \*

(B) \* \* \*

(I) Within the five consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(I) of this section, performs for that audit client the services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or Engagement Quality Reviewer, as defined in paragraph (f)(7)(ii)(B) of this section, or a combination of those services; or

\* \* \* \* \*

(e) *Transition provisions for mergers and acquisitions involving audit clients.* An accounting firm's independence will not be impaired because an audit client engages in a merger or acquisition that gives rise to a relationship or service that is inconsistent with this rule, provided that:

(1) The accounting firm is in compliance with the applicable independence standards related to such services or relationships when the services or relationships originated and throughout the period in which the applicable independence standards apply;

(2) The accounting firm has or will address such services or relationships promptly under relevant circumstances as a result of the occurrence of the merger or acquisition;

(3) The accounting firm has in place a quality control system as described in paragraph (d)(3) of this section that has the following features:

(i) Procedures and controls that monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition; and

(ii) Procedures and controls that allow for prompt identification of such services or relationships after initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the transaction.

(f) \* \* \*

(4) *Affiliate of the audit client* means:

(i) An entity that has control over the entity under audit, or over which the entity under audit has control, including the entity under audit's parents and subsidiaries;

(ii) An entity that is under common control with the entity under audit, including the entity under audit's parents and subsidiaries, when the entity and the entity under audit are each material to the controlling entity;

(iii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iv) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; or

(v) Each entity in the investment company complex as determined in paragraph (f)(14) of this section when the entity under audit is an investment company or investment adviser or sponsor, as those terms are defined in paragraphs (f)(14)(ii), (iii), and (iv) of this section.

(5) \* \* \*

(iii) The “audit and professional engagement period” does not include periods ended prior to the first day of the last fiscal year before the issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with applicable independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(6) *Audit client* means the entity whose financial statements or other information is being audited, reviewed, or attested to and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraphs (f)(4)(iii), (f)(4)(iv), or (f)(14)(i)(E) of this section.

\* \* \* \* \*

(14) *Investment company complex.* (i) “Investment company complex” includes:

(A) An entity under audit that is an:

(1) Investment company; or

(2) Investment adviser or sponsor;

(B) The investment adviser or sponsor of any investment company identified in paragraph (f)(14)(i)(A)(1) of this section;

(C) Any entity controlled by or controlling:

(1) An entity under audit identified by paragraph (f)(14)(i)(A) of this section, or



(2) An investment adviser or sponsor identified by paragraph (f)(14)(i)(B) of this section.

When the entity is controlled by an investment adviser or sponsor identified by paragraph (f)(14)(i)(B), such entity is included within the investment company complex if:

(i) The entity and the entity under audit are each material to the investment adviser or sponsor identified by paragraph (f)(14)(i)(B) of this section; or

(ii) The entity is engaged in the business of providing administrative, custodial, underwriting, or transfer agent services to any entity identified by paragraphs (f)(14)(i)(A) or (B) of this section;

(D) Any entity under common control with an entity under audit identified by paragraph (f)(14)(i)(A) of this section, any investment adviser or sponsor identified by paragraph (f)(14)(i)(B) of this section, or any entity identified by paragraph (f)(14)(i)(C) of this section; if the entity:

(1) Is an investment company or an investment adviser or sponsor, when the entity and the entity under audit identified by paragraph (f)(14)(i)(A) of this section are each material to the controlling entity; or

(2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any entity identified by paragraphs (f)(14)(i)(A) and (f)(14)(i)(B) of this section;

(E) Any entity over which an entity under audit identified by paragraph (f)(14)(i)(A) of this section has significant influence, unless the entity is not material to the entity under audit identified by paragraph (f)(14)(i)(A) of this section, or any entity that has significant influence over an entity under audit identified by paragraph (f)(14)(i)(A) of this section, unless the entity

under audit identified by paragraph (f)(14)(i)(A) of this section is not material to the entity that has significant influence over it; and

(F) Any investment company that has an investment adviser or sponsor included in this definition by paragraphs (f)(14)(i)(A) through (f)(14)(i)(D) of this section.

(ii) An investment company, for purposes of paragraph (f)(14) of this section, means any investment company or an entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)).

(iii) An investment adviser, for purposes of this definition, does not include a subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iv) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

\* \* \* \* \*

By the Commission.

Dated: October 16, 2020.

Eduardo A. Aleman,

Deputy Secretary.