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SEC Adopts Amendments to Auditor Independence Rules

On Oct. 16, 2020, the U.S. Securities and Exchange Commission (the SEC) adopted amendments to Rule 2-01 of Regulation S-X (the Amendments), the auditor independence rules.¹ The Amendments are intended to more effectively focus the auditor independence analysis on those relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality. They were adopted largely as proposed.²

The Amendments should reduce the circumstances under which auditor relationships and services trigger non-substantive rule breaches at affiliates of an entity under audit and alleviate certain practical challenges of complying with Rule 2-01. Consequently, the Amendments may provide an opportunity for audit clients and audit committees to more effectively focus on relationships that could impair an auditor's objectivity and impartiality.

The Amendments are effective 180 days after publication in the Federal Register.³

Summary

The Amendments:

- Amend the definitions of “affiliate of the audit client” and “investment company complex” (ICC) to exclude certain affiliates based on materiality thresholds and to clarify the applicability of each definition.
- Shorten the auditor independence look-back period for domestic issuers that are first-time SEC filers to treat domestic issuers and foreign private issuers similarly.
- Exclude certain student loans and de minimis consumer loans from the list of prohibited lending relationships.
- Replace the reference to “substantial stockholders” in the business relationship rule with the concept of beneficial owners with significant influence.
- Clarify the applicability of certain provisions to refer to the entity under audit rather than an affiliate.
- Introduce a transition framework for merger and acquisition transactions in assessing compliance with the auditor independence rules.
- Make certain other minor updates.

Background

The U.S. federal securities laws require SEC issuers and certain other entities to utilize independent accountants for their financial statement audits.⁴ Rule 2-01(b) sets forth the general standard for an accountant to be deemed independent of its audit clients, and Rule

2-01(c) provides a nonexclusive list of circumstances that the SEC considers to be inconsistent with the general independence standard.⁵ This includes restrictions on financial, employment, and business relationships between an auditor and its audit client, as well as restrictions on an auditor providing certain non-audit services to an audit client.⁶ The term “audit client” under Rule 2-01 includes the entity under audit as well as certain affiliates of that entity. Consequently, identifying entities that are affiliates of the entity under audit determines where the auditor and the audit client need to monitor for prohibited relationships and services.⁷

Amendments

Affiliate of the Audit Client and ICC Definitions

Current Rule 2-01 broadly defines the term “audit client” to include not only the entity whose financial statements are being audited (i.e., the entity under audit) but also its parents, subsidiaries and any affiliates under common control with the audit client (i.e., sister entities).⁸ In addition, when the audit client is an investment company or other entity that is part of an ICC, the current definition of audit client also includes each entity in the ICC.⁹ The Amendments revise each definition and clarify that the amended definition of “affiliates of the audit client” should be applied to an operating company under audit (each, an Operating Company),¹⁰ while the amended ICC definition should be applied to each entity under audit that is an investment company or an investment adviser or sponsor (each, an ICC Audit Entity).¹¹

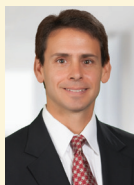
Operating Company Audit Clients. With respect to Operating Companies (including portfolio companies), the Amendments narrow the scope of implicated affiliates by generally excluding sister entities unless a sister entity and the entity under audit are each material to the controlling entity (a dual materiality threshold). Specifically, the amended “affiliate of the audit client” definition would include any entity:

- controlling or controlled by the Operating Company under audit, including the Operating Company’s parents and subsidiaries;

- under common control with the Operating Company or its parents and subsidiaries (i.e., sister entities), if the entity and the Operating Company are each material to the controlling entity;¹²
- over which the Operating Company has significant influence unless the entity is not material to the Operating Company; and
- that has significant influence over the Operating Company, unless the Operating Company is not material to such entity.

ICC Audit Clients. The Amendments to the ICC definition similarly exclude certain entities in a control relationship unless the affiliated entity and the ICC Audit Entity are each material to the controlling entity. The Amendments also include within the term “investment company” (for purposes of the ICC definition) registered investment companies and entities that are not considered investment companies pursuant to the exclusions in Section 3(c) of the 1940 Act (i.e., unregistered or private funds). The current ICC definition only includes an unregistered fund if it has an investment adviser or sponsor already included as an affiliate within that ICC definition.¹³ Specifically, the amended ICC definition would:

- Reiterate that the investment adviser or sponsor of any entity under audit that is an investment company is covered (each, an Adviser Entity and, together with the ICC Audit Entities, the Primary ICC Entities).
- Include any entity controlled by or controlling any Primary ICC Entities, except that any entity controlled by an Adviser Entity is only included if: the entity and the ICC Audit Entity are each material to the Adviser Entity; or the entity is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services (collectively, IC Services) to any Primary ICC Entity (such control affiliates collectively, Downstream/Upstream ICC Entities).¹⁴



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- Include any entity under common control with any Primary ICC Entity or Downstream/Upstream ICC Entity if the entity: is an investment company, investment adviser or sponsor, when the entity and the ICC Audit Entity are each material to the controlling entity; or is engaged in the business of providing IC Services to any Primary ICC Entity (such control affiliates collectively, Sister ICC Entities).
- Include any entity over which an ICC Audit Entity has significant influence unless the entity is not material to such ICC Audit Entity; or any entity that has significant influence over an ICC Audit Entity, unless the ICC Audit Entity is not material to such entity.¹⁵
- Include any investment company that has an investment adviser or sponsor that is a Primary ICC Entity, a Downstream/Upstream ICC Entity, or a Sister ICC Entity.¹⁶

General Independence Standard. The SEC reaffirmed its view that the general independence principles of Rule 2-01(b) will continue to apply to relationships and services to affiliates that are covered under current Rule 2-01 but would no longer be covered as a result of the Amendments (e.g., if fewer sister entities are deemed affiliates of the entity under audit). Consequently, sister entities that are not considered affiliates under amended Rule 2-01 would still need to be identified and monitored for the auditor to appropriately consider and apply the general independence standard of Rule 2-01(b) on an ongoing basis. In addition, there can be qualitative and quantitative changes that require a re-assessment of the materiality of the entity under audit and its sister entities.

Look-Back Period for First-Time Filers

When a company files, or is required to file, a registration statement or report with the SEC for the first time, the auditor generally must be independent with respect to the company (and applicable affiliates) during all periods included in the company's registration statement or report filed with the SEC (i.e., the look-back period).¹⁷ However, the look-back period for foreign private issuers that are first-time filers is currently shorter and starts with the first day of the last fiscal year, provided there has been full compliance with home country independence standards in all prior periods covered by the registration statement or report filed with the SEC. The Amendments apply this same standard to domestic issuers that are first-time filers, except that domestic issuers must comply with applicable auditor independence standards for prior periods covered by the filing.

Lending Relationships—Loan Rule

The Loan Rule addresses certain lending relationships that could impair an auditor's independence.¹⁸ The Amendments add an additional exception to the Loan Rule with respect to student loans and clarify that the current mortgage loan exclusion may apply to multiple mortgage loans.¹⁹

The Amendments also clarify the focus of certain provisions on the entity under audit. With certain exceptions, the Loan Rule generally prohibits lending relationships between the audit firm (including covered persons and family members) and beneficial owners of equity securities of the "audit client," which includes beneficial owners of covered affiliates of the entity under audit, that are known through reasonable inquiry and where such owners have significant influence over the audit client (which could be read to include the entity under audit and its covered affiliates). The Amendments clarify that this analysis should focus on whether such beneficial owners have significant influence over the entity under audit and not whether such beneficial owners have significant influence over an affiliate of the entity under audit.

Similarly, the Amendments also clarify that the Loan Rule prohibition on loans to or from the audit client's officers and directors would only include persons associated with an affiliate of the entity under audit if such persons have the ability to affect decision-making at the entity under audit.

Lending Relationships—Credit Card Rule

The credit card rule generally prohibits any aggregate outstanding credit card 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. The Amendments replace the reference to "credit card" with "consumer loan," which is intended to encompass and exclude additional types of consumer financing borrowers routinely obtain for personal consumption subject to the same de minimis conditions.²⁰

Business Relationships Rule

The Business Relationships Rule prohibits the accounting firm or any covered person in the firm 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."²¹ Similar to the Loan Rule, the Amendments clarify that persons associated with the audit client in a decision-making capacity would only include persons associated with an affiliate of the entity under audit if such persons would be able to exert decision-making capacity over the entity under audit. The Amendments also align the Business Relationships Rule with the Loan Rule by replacing the reference to substantial stockholders (which is not defined in Regulation S-X) with a significant influence analysis. That is, an auditor would look to whether any beneficial owners of the equity securities of the entity under audit (or beneficial owners of covered affiliates of the entity under audit) that are known through reasonable inquiry have significant influence over the entity under audit instead of looking to substantial stockholders.²²

Inadvertent Violations for Mergers and Acquisitions

The Amendments provide a transition framework for mergers and acquisitions to address inadvertent auditor independence violations, where the services or relationships that are the basis for a violation were not prohibited by applicable independence standards before the consummation of such corporate event. If certain conditions are met, the auditor's independence would not be impaired due to an inadvertent violation, and such services or relationships would not be considered violations under amended Rule 2-01.²³

Miscellaneous Updates

The Proposed Amendments also include a few miscellaneous updates to Rule 2-01, such as conforming amendments to replace references to concurring partner (i.e., the audit partner conducting a quality review) with the term "Engagement Quality Reviewer" and deleting outdated transition and grandfathering provisions.

¹ *Qualifications of Accountants*, Release No. 33-10876 (Oct. 16, 2020) (the Adopting Release), available at <https://www.sec.gov/rules/final/2020/33-10876.pdf>. SEC Commissioners Lee and Crenshaw dissented.

² See *Amendments to Rule 2-01, Qualifications of Accountants*, Release No. 33-10738 (Dec. 30, 2019).

³ 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.

⁴ See, e.g., Sections 30(e) and 30(g) of the Investment Company Act of 1940, as amended (the 1940 Act) and Rule 30e-1 thereunder (requiring registered investment companies to transmit annually to shareholders financial statements audited by an independent accountant); Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the custody rule provides an audit exception to certain pooled investment vehicles if, among other things, the vehicle is subject to annual audit by an independent public accountant).

⁵ Rule 2-01(b) provides that the SEC will not recognize an accountant as independent with respect to an audit client if the accountant is not, or if 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 auditor independence rules of the Public Company Accounting Oversight Board ("PCAOB") also apply to audits of SEC registrants and issuers. The PCAOB is expected to amend its ethics and independence rules to conform with the Amendments.

⁶ Note: The auditor independence rules of the Public Company Accounting Oversight Board (PCAOB) also apply to audits of SEC registrants and issuers.

⁷ Identifying affiliates of the audit client under current Rule 2-01 can be particularly challenging in complex organizational structures, such as large ICCs, since essentially all sister entities are currently included

regardless of whether they are material to the controlling entity. In the investment company and private equity context, for example, there is a significant volume of acquisitions and dispositions of unrelated portfolio companies that are under common control and thus could be deemed affiliates. This may result in an expansive and constantly changing list of affiliates to be considered as part of the auditor independence analysis, even where the relationships being monitored are not likely to threaten the auditor's objectivity and impartiality.

⁸ Other entities that control or are controlled by the entity under audit would also be affiliates.

⁹ Under current Rule 2-01(f)(14), "investment company complex" includes: (A) an investment company and its investment adviser or sponsor; (B) any entity controlled by or controlling such investment adviser or sponsor, or any entity under common control with the investment adviser or sponsor if the entity: (1) is itself an investment adviser or sponsor; or (2) is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and (C) any investment company or entity that would be an investment company but for the exclusions provided by Section 3(c) of the 1940 Act, as amended, that has an aforementioned investment adviser or sponsor (under paragraph (A) or (B)). Note that an investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser; and a sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

¹⁰ Specifically, amended Rules 2-01(f)(4)(i) through (iv). An operating company is an entity that is not an investment company, investment adviser, or sponsor; and a portfolio company is a type of operating company that has investment companies or unregistered funds in private equity structures among its investors.

¹¹ If an auditor audits both an Operating Company and, on a standalone basis, an ICC Audit Entity within the same corporate organizational structure, then the auditor would have to apply the "affiliate of the audit client" definition to the Operating Company and the ICC definition to the ICC Audit Entity to identify the entities that are affiliates of the respective entities under audit. With respect to identifying affiliates of an Operating Company with a subsidiary that serves as an investment adviser to investment companies, the SEC noted that the investment adviser generally will have a controlling relationship over the investment companies.

¹² The SEC did not provide any specific guidance on materiality since auditors and their audit clients have developed approaches to determine materiality in compliance with current provisions of Rule 2-01.

¹³ The Amendments also make conforming revisions and clarifications to the ICC definition to align it with the definition of affiliate of the audit client, since any ICC Audit Entity would look solely to the amended ICC definition to identify affiliates under amended Rule 2-01. That is, certain of the amendments to the ICC definition are designed to capture some entities that are covered by the current "affiliates of the audit client" definition (e.g., by virtue of a control or significant influence relationship), but not necessarily covered under the current ICC definition.

¹⁴ This provision is specifically designed to exclude portfolio companies of an affiliate sister investment company where the investment company under audit and such portfolio companies are not material to the shared Adviser Entity and the portfolio companies are not otherwise engaged in providing IC Services to any Primary ICC Entity.

¹⁵ The Proposed Amendments also make conforming changes to the definition of “audit client,” which excludes, for the purpose of considering certain investment relationship prohibitions under Rule 2-01, entities that are deemed affiliates solely because of the significant influence prong.

¹⁶ The current common control prong under the ICC definition does not explicitly include investment companies in the assessment of sister entities, but any investment company advised or sponsored by a sister investment adviser is already included as an affiliate (regardless of materiality).

Note: The amended Loan Rule excluded from the definition of “audit client” for purposes of the Loan Rule, for a fund under audit, any other fund (e.g., a sister fund) that otherwise would be considered an affiliate of the audit client.

¹⁷ For a domestic issuer engaging in an initial public offering, for example, this could include multiple years of financial statements with respect to which the company’s auditor has to have maintained its independence from the company under SEC (and PCAOB) auditor independence rules. These rules could impose additional requirements or otherwise differ from the auditor independence standards applied by other rule-making and standard-setting bodies, such as the Association of International Certified Professional Accountants, that were applicable to the issuer as a private company.

¹⁸ That is, Rule 2-01(c)(1)(ii)(A) of Regulation S-X. Specifically, the Loan Rule provides that an accountant is not independent when the accounting firm, any covered person in the firm (e.g., the audit engagement team and those in the chain of command), or any of the covered persons’ immediate family members, has any loans to or from the audit client, certain beneficial owners of the audit client, or the audit client’s officers and directors, except for four types of loans obtained from a financial institution

under its normal lending procedures, terms, and requirements: (i) automobile loans and leases collateralized by the automobile, (ii) loans fully collateralized by the cash surrender value of an insurance policy, (iii) loans fully collateralized by cash deposits at the same financial institution, and (iv) a mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

The SEC most-recently adopted amendments to the Loan Rule in June 2019. *See SEC Adopts Amendments to Loan Rule, Stradley Ronon Client Alert* (July 2, 2019) (Loan Rule Client Alert), available at https://www.stradley.com/-/media/files/publications/2019/07/client_alert_img_july_2_2019.pdf.

¹⁹ Such loans must be obtained by an audit firm’s covered persons (or their immediate family members) from a financial institution under the financial institution’s normal lending procedures, terms, and requirements, provided the loans were not obtained while the covered person in the firm was a covered person.

²⁰ *See* Rule 2-01(c)(1)(ii)(E). Examples include retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence.

²¹ *See* Rule 2-01(c)(3).

²² For more information regarding the significant influence analysis, *see, e.g.*, Loan Rule Client Alert.

²³ Under this transition framework, the auditor must, among other things, be in compliance with the applicable independence standards when the services or relationships in question originated and throughout the applicable period, correct the independence violations promptly after the effective date of the merger or acquisition, and have in place a quality control system (as described in Rule 2-01(d)(3)) that addresses certain procedures and controls for merger and acquisition activity.