February 12, 2020

SEC Proposes Amendments to Modernize Auditor Independence Rule

On December 30, 2019, the SEC issued a release containing proposed amendments to its auditor independence rule, Rule 2-01 of Regulation S-X. Among other things, the proposed amendments would amend the definitions of "affiliates of the audit client" and "investment company complex" by adding "materiality" qualifiers to the common control provisions within these definitions. This would have the effect of narrowing the number of common control affiliates of the audit client that an auditor must monitor for relationships that can impair the auditor's independence.

This Alert summarizes key aspects of these proposed amendments.

BACKGROUND

Under the current auditor independence rule, the term "**audit client**" includes any "**affiliates of the audit client**" (each, an "AAC"). An AAC is defined to include:

- Any 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; and
- When the audit client is an investment company or investment adviser, each entity in the investment company complex.

The term "**investment company complex**" ("ICC") includes any entity controlled by or controlling an investment adviser, as well as any entity under common control with an investment adviser if the entity: (i) is an investment adviser or (ii) is engaged in the business of providing administrative, custodian, underwriting or transfer agent services to any investment company or investment adviser.

Under these definitions, entities that are under common control with an audit client are deemed AACs and, therefore, fall within the definition of audit client. In addition, when an audit client is an entity within an ICC, each of the entities within the definition of ICC are AACs and similarly falls within the definition of audit client. Therefore, an auditor's lack of independence with respect to one entity within a complex corporate organization or within an ICC potentially renders the auditor non-independent with respect to every entity in the corporate organization or in the ICC.

In the proposing release, the SEC noted that it had "observed some challenges in the practical application of the 'common control' component of the [AAC] definition" and stated:

In the private equity and investment company context, where there potentially is a significant volume of acquisitions and dispositions of unrelated portfolio companies, the definition of [AAC] may result in an expansive and constantly changing list of entities that are considered to be [AACs]. Such changes in portfolio companies can create compliance challenges for audit firms performing independence analyses by requiring them to monitor their various relationships and services with [AACs], even if many of those relationships and services likely would not threaten the auditor's objectivity and impartiality. (Footnote omitted).

As explained below, the proposed amendments would address this compliance issue by (i) introducing "materiality" qualifiers to focus the analyses in common-control scenarios "on those relationships and services that are most likely to threaten auditor objectivity and impartiality" and (ii) distinguishing how the common control provisions within the AAC and ICC definitions apply, depending on whether the audit client is a portfolio company, an investment company or an investment adviser.

Nonetheless, despite the materiality qualifiers, the SEC stated that a determination under the proposed amendments that a controlled entity is not material to the controlling entity, by itself, does not conclude the independence analysis under Rule 2-01. Auditors and audit clients must still consider all relevant facts and circumstances when assessing independence pursuant to the general standard in Rule 2-01(b).[1]

PROPOSED AMENDMENTS

I. Common Control and "Affiliate of the Audit Client" Definition

The SEC would amend the AAC definition [Rule 2-01(f)(4)] to include a materiality requirement with respect to operating companies that are under common control.[2] When applying the AAC definition to operating companies, including portfolio companies, the proposed AAC definition would focus the auditor independence analysis on entities under common control with the audit client ("sister entities") that are material to the controlling entity. Specifically, the proposal would qualify the AAC definition with the phrase: "unless the entity is not material to the controlling entity."

The SEC provided the following example:

Example 1. Parent company A controls three operating companies, including operating company B. The auditor of operating company B would need to consider whether either of the other two sister entities are material to parent company A to determine whether one or both of the sister entities are AACs of company B.

If neither of the sister entities is material to parent company A, the auditor is not required to monitor its relationships and services[3] with the sister entities.

In addition, the SEC would amend the AAC definition to provide that the identification of sister entities of a portfolio company that is the audit client must occur under the proposed AAC definition, instead of under the proposed ICC definition [proposed Rule 2-01(f)(14)]. This simply reflects that fact that the portfolio company is the entity under audit and does not fall within the proposed ICC definition (discussed below).

The SEC provided the following example:

Example 2. Portfolio company C is controlled by private fund D. While portfolio company C is controlled by an entity within the proposed ICC definition, the auditor of portfolio company C would still look to the proposed AAC definition, and not the proposed ICC definition, to determine the AACs of portfolio company C.

In short, the proposed AAC definition would operate to exclude sister entities that are not material to the controlling entity from being deemed AACs. The SEC believes that this approach would relieve some of the compliance burden of undertaking auditor independence analyses because of the reduction in the number of entities that would be deemed AACs.

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[1] Rule 2-01(b) provides, in part: "The Commission will not recognize an accountant as independent . . . if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."

[2] In the proposing release, the SEC stated (i) "operating company" refers to entities that are not investment companies, investment advisers or sponsors and (ii) "portfolio company" refers "to an operating company that has among its investors, investment companies or unregistered funds in private equity structures."

[3] Rule 2-01(c) contains a non-exhaustive list of relationships that render an auditor non-independent of an audit client. The relationships include financial, employment, and business relationships, as well as relationships where an auditor provides certain non-audit services to an audit client.

II. Investment Company Complex Definition

A. Entity Under Audit and Unregistered Funds

The SEC also would amend the ICC definition [Rule 2-01(f)(14)] to clarify that, when the audit client is an investment company or an investment adviser, the auditor's analyses to identify AACs should rely exclusively on the proposed ICC definition.

The proposed ICC definition affects entities that are deemed investment companies. An "investment company" for purposes of the proposed ICC definition includes registered investment companies, business development companies and entities that would be investment companies but for the exclusions provided by Section 3(c) of the 1940 Act, including private funds that rely on Section 3(c)(1) or Section 3(c)(7).[4] If an auditor is auditing only these investment company entities, it would focus solely on the proposed ICC definition to identify AACs of the investment company entities.

Continuing with its earlier example (Example 2, above), the SEC provided the following example to illustrate the combined effects of the proposed AAC definition and the proposed ICC definition:

Example 3. Where an auditor is the auditor of both unregistered fund D and portfolio company C (which is controlled by unregistered fund D), the auditor would apply both the proposed AAC definition and the proposed ICC definition in its independence analysis. The auditor of portfolio company C would conduct its independence analysis under the proposed ACC definition, while the same auditor, with respect to its audit of unregistered fund D, would conduct its analysis under the proposed ICC definition to determine the AAC status of entities within the same ICC as unregistered fund D.

B. Common Control with any Investment Company or Investment Adviser

The existing ICC definition provides that any entity under common control with an investment adviser of an investment company audit client that is also an investment adviser is considered in the ICC and, therefore, an AAC of the investment company. Moreover, the existing ICC definition includes both investment companies that share an investment adviser with an investment company audit client, as well as any investment company that is advised by a sister investment adviser. Thus, at present, an auditor to an investment company is not permitted to have any prohibited relationships with, or provide any prohibited services to, any sister investment advisers or the investment companies advised by a sister investment adviser.

The SEC proposes to align the common control prong of the proposed ICC definition with the common control prong for operating companies in the proposed AAC definition by adding the qualifier "unless the entity is not material to the controlling entity" to the proposed ICC definition's common control prong [Rule 2-01(f)(14)(i)(D)]. Accordingly, the proposed ICC definition would operate to exclude from the proposed ICC definition investment advisers and investment companies that are not material to the controlling entity.

An investment company that is advised by a not-material investment adviser is ***not*** automatically excluded from the proposed ICC definition. With the addition of the materiality qualifier described above, the SEC stated that this is intended to ensure that a controlling entity's investment directly in an investment company is considered in the AAC analyses even if the investment adviser to that investment company is not material to the controlling entity.

C. Investment Companies that Share an Investment Adviser

[4] Under the existing ICC definition, an unregistered fund is included in the ICC only if its investment adviser or sponsor is already included within the existing ICC definition.

The proposed ICC definition would not change auditor independence analyses of investment companies that have an investment adviser included in the proposed ICC definition. The auditor would still be required to monitor, as part of its independence analyses, investment companies that share the same investment adviser as the investment company under audit. The SEC stated that the relationship between an investment adviser and an investment company it advises is such that, once the adviser is included in the ICC definition, all of the investment companies it advises should be included in the ICC definition.

D. Significant Influence Added to the ICC Definition

As noted above, the proposed ICC definition is intended to clarify that, when the entity under audit is an investment company or an investment adviser, the auditor should look to the proposed ICC definition to determine which entities are considered AACs. To align the proposed ICC definition with the existing "significant influence" analysis that applies to operating companies in the existing AAC definition, the SEC also proposes to include a "significant influence" prong in the proposed ICC definition. Therefore, the proposed ICC definition also would include any entity that has significant influence over an investment company or investment adviser, unless the investment company or investment adviser is not material to the entity with significant influence.

The SEC stated that the June 2019 amendments to the "Loan Rule" provisions of Rule 2-01(c) (described in this Ropes & Gray Alert) "clarified what constitutes significant influence in an investment company context and that analysis would apply here as well."

III. Other Proposed Changes

In addition, the proposed amendments would:

- Shorten the compliance look-back period to one year (from three) for domestic issuers filing or required to file a registration statement or report with the SEC for the first time ("first-time filers"),
- Introduce a transition framework for inadvertent auditor independence violations arising from merger and acquisition transactions,
- Add certain student loans and *de minimis* consumer loans to the categorical exclusions from independence-impairing lending relationships in Rule 2-01(c),[5] and
- Replace the reference to "substantial stockholder" in the business relationships rule in Rule 2-01(c) 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 audit client" to align this rule with recent changes made to the Loan Rule.

IV. Comment Period

Comments on the proposed amendments to Rule 2-01 must be received by the SEC **no later than March 16, 2020**.

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For further information about how the issues described in this Alert may impact your interests, please contact your usual Ropes & Gray attorney.

[5] *See* note 3, above.