SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 210

[Release No. 33–10738; 34–87864; FR–86; IA–5422; IC–33737; File No. S7–26–19]

RIN 3235–AM63

Amendments to Rule 2–01, Qualifications of Accountants

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing amendments to update certain auditor independence requirements as a result of recent feedback received from the public and our experience administering these requirements since their initial adoption nearly two decades ago. The proposed amendments would 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: Comments should be received on or before March 16, 2020.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

• Use the Commission's internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or

• Send an email to *rule-comments@sec.gov.* Please include File Number S7–26–19 on the subject line.

Paper Comments

• Send paper comments to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–26–19. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's website (*http://www.sec.gov/rules/proposed.shtml).* Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

We or the SEC staff (the ''staff'') may add studies, memoranda or other substantive items to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on our website. To ensure direct electronic receipt of such notifications, sign up through the ''Stay Connected'' option at *www.sec.gov* to receive notification by email.

FOR FURTHER INFORMATION CONTACT: Duc Dang, Senior Special Counsel, or Giles T. Cohen, Acting Chief Counsel, Office of the Chief Accountant, at (202) 551–5300; Alexis Cunningham, Assistant Chief Accountant, or Daniel Rooney, Assistant Chief Accountant, Chief Accountant's Office, Division of Investment Management, at (202) 551–6918; or Joel Cavanaugh, Senior Counsel, Investment Company Regulation Office, Division of Investment Management, at (202) 551–6792, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing amendments to 17 CFR 210.2–01 (''Rule 2–01'') of 17 CFR 210.01 *et seq.* (''Regulation S–X).[1]

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I. Introduction

The Commission has long recognized that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence.[2] If investors do not perceive that the auditor is independent from the audit client, they 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 [3] to be independent of their audit clients both ''in fact and in appearance.'' [4]

In 2000, the Commission adopted a comprehensive framework of rules governing auditor independence, laying out governing principles and describing certain specific financial, employment, business, and non-audit service relationships that would cause an auditor not to be independent of its audit client. The 2000 amendments set forth the standard for analysis to determine whether an auditor is

[1] Hereinafter, all references to Rule 2–01 and any paragraphs included within the rule are referring to Rule 2–01 of Regulation S–X.

[2] *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'').

[3] We use the terms ''accountants'' and ''auditors'' interchangeably in this release.

[4] *See* Preliminary Note 1 to Rule 2–01 and 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.'').

independent. Under this analysis, pursuant to Rule 2–01(b), 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.'' Rule 2–01(b) further states that the ''Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client,'' in determining whether an auditor is independent. Rule 2–01(c) then sets forth a nonexclusive list of particular circumstances that the Commission considers to be inconsistent with the independence standard in Rule 2–01(b), including certain financial, employment, business, and non-audit service relationships between an accountant and its audit client.[5]

Except for revisions made in connection with amendments required by the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley Act'')[6] and the recent amendments related to certain debtor-creditor relationships,[7] many of the provisions from the 2000 Adopting Release have remained unchanged since adoption. We seek to maintain the relevance of our auditor independence requirements, and evaluate their effectiveness in light of current market conditions and industry practices. As such, in connection with the recent proposal to address certain debtor-creditor relationships, we also solicited comment on other potential updates to the auditor independence rules.[8] After considering the feedback received from the public and our experience administering these rules since their initial adoption nearly two decades ago, we are proposing additional amendments to our auditor independence rules to more effectively focus the independence analysis on those relationships or services that we believe are most likely to threaten an auditor's objectivity and impartiality.

We welcome feedback and encourage interested parties to submit comments on any or all aspects of the proposed rule amendments. When commenting, it would be most helpful if you include the reasoning behind your position or recommendation.

II. Proposed Amendments

A. Proposed Amendments to Definitions

1. Proposed Amendments to Affiliate of the Audit Client and the Investment Company Complex

''Rule 2–01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance.''[9] The term ''audit client''[10] is defined as ''the entity whose financial statements or other information is being audited, reviewed or attested''[11] and any ''affiliates of the audit client.''[12] The 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 ''[e]ach entity in the investment company complex when the audit client is an entity that is part of an investment company complex.''[13] Rule 2–01(f)(14) defines an investment company complex (''ICC'') to include, in part, ''[a]ny entity controlled by or controlling an investment adviser or sponsor . . . or any entity under common control with an investment adviser or sponsor . . . if the entity: (1) Is 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.''

As noted above, the first paragraph of the definition of affiliate of the audit client includes ''an entity that has control over the audit client . . . or *which is under common control with the audit client,* including the audit client's parents and subsidiaries''[14] (emphasis added). As such, entities under common control with the audit client (''sister entities'') are considered affiliates and fall within the definition of the ''audit client'' set forth in Rule 2–01(f)(6). Additionally, pursuant to Rule 2–01(f)(4)(iv), each entity in an ICC is considered an affiliate when the audit client is part of the ICC. Consequently, 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 sister entities are material to the controlling entity.

In our experience administering the independence rules, we have observed some challenges in the practical application of the ''common control'' component of the definition of affiliate of the audit client. We also have observed a number of situations where a prohibited service or relationship with a sister entity did not result in a corresponding threat to an auditor's objectivity and impartiality. Additionally, several commenters have suggested that we revisit the scope of the current application of the independence rules to entities under ''common control.''[15] In the private equity and investment company context, where there potentially is a significant volume of acquisitions and dispositions of unrelated portfolio companies,[16] the definition of affiliate of the audit client may result in an expansive and constantly changing list of entities that are considered to be affiliates of the audit client. 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 affiliates of the audit client, even if many of those relationships and services likely would not threaten the auditor's objectivity and impartiality.

Furthermore, individual portfolio companies are often audited by different auditors, even when they are within the

[5] *See* Rule 2–01(c); *see also* 2000 Adopting Release, at 65 FR 76009 (''The amendments [to Rule 2–01 adopted in 2000] identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2–01(b). The relationships addressed include, among others, financial, employment, and business relationships, and relationships where auditors provide certain non-audit services between auditors and audit clients . . .'').

[6] *Strengthening the Commission's Requirements Regarding Auditor Independence,* Release No. 33–8183 (Jan. 28, 2003) [68 FR 6005 (Feb. 5, 2003)].

[7] *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'' are referring to Rule 2–01(c)(1)(ii)(A).

[8] *See Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships,* Release No. 33–10491 (May 2, 2018) [83 FR 20753 (May 8, 2018)] (''Loan Provision Proposing Release''). The comment letters received in response to the Proposing Release are available at *https://www.sec.gov/comments/s7-10-18/s71018.htm.*

[9] Preliminary note 1 to Rule 2–01.

[10] Rule 2–01(f)(6).

[11] For the purposes of our discussion in this release, we refer to this part of the definition as the ''entity under audit.''

[12] *See* Rule 2–01(f)(6). For the purpose of Rule 2–01(c)(1)(i), entities covered by Rule 2–01(f)(4)(ii) or (iii) are not considered affiliates of the audit client.

[13] Rule 2–01(f)(4)(i) and (iv).

[14] Rule 2–01(f)(4)(i).

[15] *See e.g.,* letters from PricewaterhouseCoopers LLP (June 29, 2018) (''PwC''), Center for Audit Quality (July 3, 2018) (''CAQ''), BDO USA, LLP (July 9, 2018) (''BDO''), Ernst & Young LLP (July 9, 2018) (''EY''), American Institute of Certified Public Accountants (July 9, 2018) (''AICPA''), and American Investment Council (July 9, 2018) (''AIC'').

[16] In this release, we are using the term ''portfolio company'' to refer to an operating company that has among its investors, investment companies or unregistered funds in private equity structures.

same ICC or private equity structure. Where the portfolio companies are otherwise unrelated, multiple audit firms may need to be independent of each of the entities currently deemed affiliates of the audit client. As a result, the shared responsibility of the audit client and respective audit firm to monitor the relationships and services against this often expansive and constantly changing list of affiliates as part of their independence analysis throughout the audit and professional engagement period could result in substantial compliance costs. Such compliance costs from independence monitoring arise even where the relationships being monitored are not likely to threaten the auditor's objectivity and impartiality, as discussed further below.

In addition to impacting monitoring and compliance efforts, the current application of the common control prong in Rule 2–01(f)(4)(i) to an auditor's relationships and services with sister entities also may have competitive effects on the market for audit and non-audit services. Where a potential audit client is in the market for an auditor, the number of qualified audit firms may be reduced because certain audit firms may have relationships with or provide services to sister entities that are impermissible under the current auditor independence rules regardless of the impact to the objectivity or impartiality of the audit firm. This potential reduction in the number of qualified audit firms may constrain the audit client's choice as to its preferred auditor and thereby also may have an impact on audit quality. For example, those responsible for selecting an auditor may believe a certain audit firm is the best fit from an audit quality perspective to audit one of the portfolio companies, but the audit firm would not be considered independent if it is providing a prohibited service to a sister entity, even where such sister entity is not material to the controlling entity.

To address these challenges and more effectively focus the definition of affiliate of the audit client on those relationships and services that are most likely to threaten auditor objectivity and impartiality, we propose amending both paragraphs (f)(4) (*i.e.,* the affiliate of the audit client definition) and (f)(14) (*i.e.,* the ICC definition) of Rule 2–01 to include materiality qualifiers in the respective common control provisions and to distinguish how the definition applies when an accountant is auditing a portfolio company, an investment company, or an investment adviser or sponsor.

Although the proposed amendments in this section will impact an auditor's analysis under Rule 2–01(c) by changing the population of entities that are included in the definition of audit client, the proposed amendments do not alter the application of the general standard in Rule 2–01(b). Because the Commission is not able to ascertain all the permutations of relationships or services that would impair an auditor's objectivity and impartiality, the Commission focused ''the legal standard [in Rule 2–01(b)] by including the explicit reference to 'all relevant facts and circumstances.' '' [17] 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).'' As such, notwithstanding the potential exclusion from the term audit client of entities that are currently considered affiliates of the audit client but would no longer be deemed affiliates under the proposed amendments, relationships and services between an auditor and such entities are still subject to the general standard. For example, the audit firm, or those charged with governance of the entity under audit, may identify independence concerns in fact or in appearance, individually or in the aggregate, upon considering the nature, extent, relative importance and other aspects of the services or relationships between the auditor, the controlling entity, and such sister entities that are not material to the controlling entity.

a. Proposed Amendments for Common Control and the Affiliate of the Audit Client

We are proposing to amend Rule 2–01(f)(4)(i) to include a materiality requirement with respect to operating companies under common control.[18] With respect to the application of the affiliate of the audit client definition to operating companies, including portfolio companies, we propose amending Rule 2–01(f)(4)(i) to focus the independence analysis on sister entities that are material to the controlling entity. Specifically, proposed Rule 2–01(f)(4)(i)(B) would qualify the definition with ''unless the entity is not material to the controlling entity.''

To demonstrate the application of proposed Rule 2–01(f)(4)(i)(B) to operating companies, consider the following organizational structure: A parent company (Parent Company A) has control over three operating companies, including Operating Company B. If an accountant is serving as Operating Company B's auditor, it 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 affiliates of the audit client.

As noted below, we believe it is appropriate to identify the affiliates of the audit client for a portfolio company under audit under proposed Rule 2–01(f)(4)(i) rather than under proposed Rule 2–01(f)(14). Portfolio companies are a type of operating company and, also as discussed below, often the portfolio companies are unrelated even though they are controlled by the same entity in the private equity structure or ICC.

To demonstrate the application of the proposed Rule 2–01(f)(4)(i) to portfolio companies, consider the situation where the accountant is serving as the auditor for Portfolio Company C, which is controlled by Unregistered Fund D. Even though Portfolio Company C is controlled by an entity within proposed Rule 2–01(f)(14) (discussed further below), Portfolio Company C's auditor would still look to proposed Rule 2–01(f)(4)(i)(A) through (D) and not proposed paragraph (f)(14) to determine which entities are affiliates of Portfolio Company C. That is because the portfolio company is the entity under audit and, as such, it does not fall within the definition of ICC set forth in proposed Rule 2–01(f)(14).

Based on the SEC staff's consultation experience, audit firms providing services to or having relationships with sister entities not material to the controlling entity do not typically present issues with respect to the audit firm's objectivity or impartiality. As such, we believe 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 entities do not typically pose a threat to the auditor's objectivity and impartiality.

We recognize that adding an evaluation of materiality as proposed may result in additional work to be done by audit firms with ongoing monitoring responsibilities for the purposes of compliance with the

[17] 2000 Adopting Release at 65 FR 76031.

[18] Proposed Rule 2–01(f)(4)(i)(B). In the 2000 Adopting Release, the Commission stated that ''entities, if not part of an [ICC], will be considered affiliates of the audit client if they satisfy the criteria of one of the three paragraphs of Rule 2–01(f)(4).'' 2000 Adopting Release at 65 FR 76059. The proposed amendments do not alter the scope of application for the affiliate of the audit client definition. For the purpose of this release, we use the term ''operating company'' to refer to entities that are not investment companies, investment advisers, or sponsors.

independence rules. However, the affiliate of the audit client definition already has a materiality evaluation, which is familiar to auditors and their audit clients. In particular, materiality is applied currently in the existing affiliate of the audit client definition in Rule 2–01(f)(4)(ii) and (iii).[19] Also, a materiality evaluation as it relates to sister entities is consistent, in part, with the definition of ''affiliate'' used by the American Institute of Certified Public Accountants (''AICPA'') in its ethics and independence rules, which are the independence rules typically applied when domestic companies are not subject to SEC and Public Company Accounting Oversight Board (''PCAOB'') independence requirements.[20] Auditors therefore have experience in applying a materiality standard when identifying affiliates, whether applying the independence rules of the SEC or AICPA.

We note that a determination under the proposed amendments that sister entities are not material to the controlling entity, by itself, does not conclude the independence analysis under Rule 2–01. This is because, as explained above, auditors and audit clients must consider ''all relevant facts and circumstances'' when assessing independence pursuant to the general standard in Rule 2–01(b).

We believe focusing on sister entities that are material to the controlling entity would relieve some of the compliance burden associated with making independence determinations, as there should be fewer entities considered affiliates. For the relationships and services that might nevertheless impact the auditor's independence under the general standard in Rule 2–01(b), we would expect those relationships and services individually or in the aggregate would be easily known by the auditor and the audit client because such services and relationships are most likely to threaten an auditor's objectivity and impartiality due to the nature, extent, relative importance or other aspects of the service or relationship. We also believe the proposed amendments could increase choice and competition for audit and non-audit services.

Request for Comment

1. Should we add the materiality requirement, as proposed, so that only sister entities that are material to the controlling entity are deemed to be an affiliate of the audit client? Alternatively, should we retain the current common control provision in the affiliate of the audit client definition?

2. Does the proposed amendment sufficiently focus the common control prong of the definition of affiliate of the audit client on those relationships and services that are most likely to threaten auditor objectivity and impartiality? Should we focus on the materiality of sister entities to the controlling entity, as proposed? If not, are there other amendments that would better focus on relationships and services that are more likely to threaten auditor objectivity and impartiality? For example, should we focus on whether sister entities are material to the entity under audit, in addition to whether they are material to the controlling entity? Should we consider aggregating sister entities in the materiality assessment rather than the assessment being done on an individual basis? Or is aggregation of multiple sister entities sufficiently covered by the general standard under Rule 2–01(b)?

3. Would auditors and audit clients face challenges in applying the materiality concept in this context? Would auditors face particular challenges assessing materiality in connection with private portfolio companies? If so, what are those challenges and how could they be addressed?

4. Would focusing only on sister entities that are material to the controlling entity increase the risk that auditors will be performing audits when they are not objective and impartial? If so, is the overarching consideration of all relevant facts and circumstances, as required by Rule 2–01(b), sufficient to mitigate this risk? Would focusing on sister entities that are material to the controlling entity increase the risk of appearance issues?

5. Are there other types of affiliates that should be excluded from the definition because the services and relationships with such entities rarely threaten an auditor's objectivity and impartiality?

b. Proposed Amendments to the Investment Company Complex

We are also proposing 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 solely to proposed Rule 2–01(f)(14) (*i.e.,* the ICC definition) to identify affiliates of the audit client.[21] The proposed amendments would explicitly direct auditors of an investment company or an investment adviser or sponsor to include all entities within the proposed ICC definition as affiliates of the audit client instead of conducting an analysis based on the prongs in proposed Rule 2–01(f)(4)(i). As such, we are proposing amendments to the ICC definition in Rule 2–01(f)(14) to focus the definition from the perspective of the entity under audit and align certain portions of the ICC definition with the amendments discussed in the preceding section.

Consistent with the discussion in the preceding section, while the proposed amendments to the ICC definition may alter the composition of entities that are deemed affiliates of the audit client principally due to materiality being added for sister entities, the overarching general standard in Rule 2–01(b) continues to apply.

i. Entity Under Audit and Unregistered Funds

We propose to clarify that auditors of investment companies, including unregistered funds,[22] or investment advisers or sponsors must assess whether other entities are affiliates of

[19] 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.''

[20] *See* AICPA Professional Code of Conduct *available at https://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf.* We acknowledge that the proposed amendment may not result in the same number of sister entities being deemed material to the controlling entity under our rules and the AICPA rules. For example, in defining control the AICPA uses the accounting standards adopted by the Financial Accounting Standards Board, whereas our rules define 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 both the entity under audit and the sister entity are material to the entity that controls both. The proposed amendment only focuses on the materiality of the sister entity to the controlling entity because we believe 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.

[21] Proposed Rule 2–01(f)(4)(ii).

[22] 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 Investment Company Act of 1940. Registered investment advisers acting as qualified custodians that have custody of client funds or securities generally are required by 17 CFR 275.206(4)–2 (Rule 206(4)–2 (the ''Custody Rule'') under the Investment Advisers Act of 1940 (the ''Investment Advisers Act'')) to obtain a surprise examination conducted by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB or, for pooled investment vehicles, may be deemed to comply with the requirement by distributing financial statements audited by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB to the pooled investment vehicle's investors.

the audit client by focusing solely on proposed Rule 2–01(f)(14).

Unlike the current ICC definition, the proposed amendments would reference the entity under audit in proposed paragraph (f)(14)(i)(A) as the starting point for the analysis of which entities are to be considered part of an ICC. As a result, when the entity under audit is an investment company, an investment adviser or a sponsor, the auditor would focus solely on proposed Rule 2–01(f)(14) to determine what other entities are part of the ICC and, therefore, affiliates of the audit client. We also are proposing 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.'' [23] As such, proposed paragraph (f)(14)(iv) would cover registered investment companies, business development companies, and entities that would be investment companies but for the exclusions provided by section 3(c) of the Investment Company Act, such as private funds that rely on section 3(c)(1) or 3(c)(7). If an auditor is auditing only these entities, it would look solely to proposed Rule 2–01(f)(14) to determine which entities are affiliates of the audit client. This would more effectively focus the independence analysis for unregistered funds under audit and align with the analysis to be undertaken for registered investment companies.

If an auditor audits *both* a portfolio company and an investment company or an investment adviser or sponsor, then the auditor would have to apply both proposed Rules 2–01(f)(4)(i) and (f)(14) to identify the entities that are affiliates of the audit client and where it would need to monitor for prohibited relationships and services. To demonstrate this using the example from the preceding section, where the accountant is serving as the auditor of both Unregistered Fund D and Portfolio Company C, which is controlled by Unregistered Fund D, the auditor would apply both proposed Rules 2–01(f)(4)(i) and (f)(14) in connection with its independence analysis. Specifically, the auditor of Portfolio Company C would conduct its analysis under proposed Rule 2–01(f)(4)(i), while the same auditor, with respect to its audit of Unregistered Fund D, would conduct its analysis under proposed Rule 2–01(f)(14) to determine the affiliate status of entities within the same ICC as Unregistered Fund D. However, if an auditor audits only an investment company or investment adviser or sponsor, as defined by proposed Rule 2–01(f)(14), then it would look solely to proposed Rule 2–01(f)(14) to determine the affiliates it would have to monitor for prohibited relationships and services.

Request for Comment

6. Should the proposed ICC definition specifically reference the entity under audit and explicitly define investment companies, for the purpose of proposed paragraph (f)(14), to include unregistered funds, as proposed?

7. Is it appropriate to direct auditors of an investment adviser, sponsor, or investment company to the investment company complex definition, as we propose to amend it, to determine the entities that will be considered affiliates of the audit client? Why or why not? Would that lead to more consistent independence analyses by auditors of these entities?

ii. Common Control With Any Investment Company, Investment Adviser or Sponsor

Under the current ICC definition, any entity under common control with an investment adviser or sponsor of an investment company [24] audit client that is also an investment adviser or sponsor (''sister investment adviser or sponsor'') is considered part of the ICC, and thereby an affiliate of the audit client.[25] Additionally, the current ICC definition includes not just the investment companies that share an investment adviser or sponsor with an investment company audit client, it also includes any investment company advised by a sister investment adviser or has a sister sponsor.[26]

To demonstrate the application of the current definition of ICC, consider the following example: An investment company, Investment Company A, is the entity under audit. Investment Company A is advised by Investment Adviser B. Investment Adviser B is under common control with Investment Adviser C and Investment Adviser D. Under current Rule 2–01(f)(14)(i)(B)(*1*), Investment Adviser C and Investment Adviser D are considered sister investment advisers and, therefore, are affiliates of the audit client Investment Company A. Moreover, every investment company advised by Investment Adviser C and Investment Adviser D falls within the definition of ICC and, therefore, is also an affiliate of the audit client Investment Company A because of the application of current Rule 2–01(f)(14)(i)(C). In this instance, the auditor could not have any prohibited services or relationships with any of the sister investment advisers or any of the investment companies they advise.

We are proposing to align the common control prong of the proposed ICC definition (proposed Rule 2–01(f)(14)(i)(D)) with the proposed common control prong for operating companies (proposed Rule 2–01(f)(4)(i)(B)), for the same reasons we discuss in Section II.A.1.a. As a result, proposed paragraph (f)(14)(i)(D)(*1*) of the ICC definition includes only sister investment companies, advisers, and sponsors that are material to the controlling entity. If the sister investment company, adviser, or sponsor is not material to the controlling entity, the general standard under Rule 2–01(b) would still apply, as discussed above.

Under the current ICC definition, an investment company seeking an auditor to audit its financial statements is precluded from considering any accountant with services or relationships prohibited by Rule 2–01(c) with sister investment advisers, sponsors, or any of the investment companies they advise or sponsor. As such, an investment company's choices among qualified auditors may be limited. The inclusion of a materiality qualifier in proposed paragraph (f)(14)(i)(D)(*1*) may broaden the pool of prospective accountants the potential investment company audit client can evaluate and consider to engage as its auditor while being unlikely to increase the potential threat to an auditor's objectivity and impartiality. Proposed paragraph (f)(14)(i)(D) is not meant to change the population of controlling entities an auditor should consider when assessing common control under the current Rule 2–01(f)(14)(i)(B), but rather to be consistent with the common control provision in proposed Rule 2–01(f)(4)(i)(B), with the primary change being the inclusion of a materiality qualifier. Because of the changes to the ICC definition discussed in the preceding section, which direct auditors

[23] *See* proposed Rule 2–01(f)(14)(iv). This is in contrast to current Rule 2–01(f)(14)(i)(C) which includes an unregistered fund only if it has an investment adviser or sponsor already included within the definition of investment company complex. *Revision of the Commission's Auditor Independence Requirements,* Release No. 33–7870 (June 30, 2000) [65 FR 43147, 43181 (July 12, 2000)].

[24] As noted in the preceding section, since proposed Rule 2–01(f)(14)(iv) defines investment company to include entities that would be considered investment companies but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940, when we use the term investment company in this release to discuss the proposed amendments, the term also includes such entities.

[25] Rule 2–01(f)(14)(i)(B)(*1*).

[26] Rule 2–01(f)(14)(i)(C).

and the audit client to look solely to proposed Rule 2–01(f)(14) to identify affiliates of the audit client with respect to an entity under audit that is an investment company or an investment adviser or sponsor, the proposed amendment discussed in this section simply aligns with the change in proposed Rule 2–01(f)(4)(i)(B).

Additionally, current Rule 2–01(f)(14)(i)(B) does not include investment companies whereas proposed paragraph (f)(14)(i)(D)(*1*) does include investment companies in the assessment of sister entities. We are introducing the reference to investment companies in the proposed ICC common control provision because, under current Rule 2–01(f)(14)(i)(C), any investment company advised or sponsored by a sister investment adviser is already included as an affiliate, regardless of materiality. With the addition of the materiality requirement in proposed paragraph (f)(14)(i)(D)(*1*), we did not want to exclude investment companies that are material to the controlling entity from the ICC when such investment companies' investment advisers or sponsors are not material to the controlling entity. This is intended to ensure that a controlling entity's investment directly in an investment company is considered in the affiliate analysis in the event that the adviser to that investment company is deemed not material to the controlling entity. We do not believe that this would expand the scope of entities determined to be affiliates based on the current application of Rule 2–01(f)(14)(i)(B) and (C).

Furthermore, we proposed to add a reference to proposed paragraph (f)(14)(i)(C) within proposed paragraph (f)(14)(i)(D) to align with the concept of parent and subsidiaries found in proposed paragraph (f)(4)(i)(B). This is intended to ensure that entities downstream and upstream to the entity under audit are considered in the analysis for common control.

Request for Comment

8. Should we include a materiality qualifier in Rule 2–01(f)(14)(i)(D), as proposed, so that only sister investment companies or investment advisers or sponsors that are material to the controlling entity are included in the proposed definition of ICC and, as a result, are deemed to be an affiliate of the audit client? Should we focus on whether sister investment companies, advisers, or sponsors are material to the investment company, adviser, or sponsor under audit, in addition to whether they are material to the controlling entity? Should we consider aggregating sister entities in the materiality assessment rather than the assessment being done on an individual basis? Or is aggregation of multiple sister entities sufficiently covered by the general standard under Rule 2–01(b)?

9. Does the proposed amendment sufficiently focus the common control prong of the ICC definition on those relationships and services that are most likely to threaten auditor objectivity and impartiality? Should the analysis focus on the materiality of sister entities to the controlling entity, as proposed?

10. Would auditors and audit clients face challenges in applying the materiality concept in this context? Would auditors face particular challenges assessing materiality in connection with unregistered funds? If so, what are the challenges and how could they be addressed?

11. Would focusing only on sister entities that are material to the controlling entity increase the risk that auditors will be performing audits when they are not objective and impartial? If so, is the overarching consideration of all relevant facts and circumstances, as required by Rule 2–01(b), sufficient to mitigate this risk? Would focusing on sister entities that are material to the controlling entity increase the risk of appearance issues?

12. Is it appropriate for auditors to assess whether or not sister investment companies are material to the controlling entity even when a sister fund's investment adviser may not be material to the controlling entity? Should we include a reference to paragraph (f)(14)(i)(C) within paragraph (f)(14)(i)(D), as proposed?

iii. Investment Companies That Share an Investment Adviser or Sponsor Included Within the ICC Definition

Under current paragraph (f)(14)(i)(C) of the ICC definition, an auditor of an investment company has to monitor for prohibited services and relationships with sister investment companies that have the same investment adviser or sponsor or have an investment adviser or sponsor that is under common control, regardless of whether the sister investment companies are material to such investment adviser or sponsor. The proposed amendments would not change the analysis of sister investment companies that have an investment adviser or sponsor included within the ICC definition. This is because proposed paragraph (f)(14)(i)(F) would include within the ICC definition any investment company that has any investment adviser or sponsor that is an affiliate of the audit client pursuant to proposed paragraphs (f)(14)(i)(A) through (D).

For example, proposed paragraph (f)(14)(i)(B) includes the investment adviser or sponsor of an investment company under audit. As the language in neither proposed paragraph (f)(14)(i)(B) nor proposed paragraph (F) includes a materiality requirement, under proposed paragraph (f)(14)(i)(F), an auditor would need to consider as part of its independence analysis, sister investment companies that have the same investment adviser or sponsor as the investment company under audit, regardless of whether such sister investment companies are material to the shared investment adviser or sponsor. Consistent with current paragraph (f)(14)(i)(C), we continue to believe that the nature of the relationship between an investment adviser or sponsor and the investment companies it advises is such that once an investment adviser or sponsor is included within the proposed ICC definition, the investment companies it advises should be included as well.

Request for Comment

13. Should paragraph (f)(14)(i)(F) be adopted as proposed? Should we instead include a materiality qualifier for sister investment companies in proposed paragraph (f)(14)(i)(F)?

iv. Significant Influence Within the ICC Definition

As discussed above, the proposed ICC definition would clarify that when the entity under audit is an investment company or an investment adviser or sponsor, the auditor should look to the proposed ICC definition in proposed Rule 2–01(f)(14) to determine which entities are considered affiliates of the audit client. As such, we propose including in the proposed ICC definition a significant influence prong to align, in part, with the current significant influence analysis applicable to operating companies in the definition of affiliate of the audit client in Rule 2–01(f)(4)(ii) and (iii).[27] Given that ''significant influence'' is used in other parts of the Commission's independence rules, including within the affiliate definition, the concept of ''significant influence'' is one with which audit firms and their clients are already required to be familiar.[28]

[27] The proposed amendments to the affiliate of the audit client definition include conforming amendments to list these two prongs as proposed Rule 2–01(f)(4)(i)(C) and (D).

[28] The Loan Provision Adopting Release clarified what constitutes significant influence in an investment company context and that analysis

Continued

Again, because of the changes to the ICC definition discussed above, which direct auditors and the audit client to look solely to proposed Rule 2–01(f)(14) to identify affiliates of the audit client with respect to an entity under audit that is an investment company or an investment adviser or sponsor, the proposed amendment discussed in this section simply aligns with the significant influence prongs in the current definition of affiliate of the audit client.

Additionally, we are also proposing a conforming amendment to the definition of the term audit client in Rule 2–01(f)(6) to include a reference to proposed Rule 2–01(f)(14)(i)(E) to be consistent with the existing references in such definition to the significant influence prongs of the affiliate of the audit client definition. Currently Rule 2–01(f)(6), for the purposes of considering investment relationship prohibitions under current Rule 2–01(c)(1)(i), excludes from the audit client definition entities that are deemed affiliates solely because of the significant influence prongs in current paragraphs (f)(4)(ii) and (iii). This conforming amendment would add a reference to proposed Rule 2–01(f)(14)(i)(E) to those exclusions.

Request for Comment

14. Should we incorporate a significant influence prong into the ICC definition, as proposed?

15. Should we also adopt the proposed conforming amendment to Rule 2–01(f)(6) to include the reference to proposed paragraph (f)(14)(i)(E)?

2. Proposed Amendment To Audit and Professional Engagement Period

Currently, paragraphs (c)(1) through (5) of Rule 2–01 enumerate certain circumstances that, if they occur during the ''audit and professional engagement period,'' are inconsistent with the general independence standard of Rule 2–01(b).[29] Under the current rule, the term ''audit and professional engagement period'' is defined differently for domestic issuers and foreign private issuers (''FPIs'') [30] with respect to situations in which a company first files, or is required to file, a registration statement or report with the Commission. Specifically, Rule 2–01(f)(5)(i) and (ii) defines 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. . . .'' However, paragraph (iii) of the definition narrows the audit and professional engagement period to just 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'' (emphasis added).

The narrower definition applicable to FPIs creates a disparate application of the auditor independence rules between domestic issuers and FPIs when, for example, both types of audit clients are engaging in an IPO. The auditor of a domestic issuer engaging in an IPO has to be independent in accordance with Rule 2–01 during all periods included in the issuer's registration statement filed with the Commission. For example, if the registration statement includes three years of financial statements, then the auditor of a domestic issuer engaging in an IPO would have to look back three years and assess independence under Rule 2–01 during all such prior years. Conversely, the auditor of an FPI engaging in an IPO has to be independent in accordance with Rule 2–01 only during the immediately preceding fiscal year. Even if the registration statement for the FPI includes three years of financial statements, the auditor and the FPI would, for purposes of Rule 2–01, look back and assess independence only during the most recently completed fiscal year provided the FPI has been in full compliance with its home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

As a consequence, a domestic private company may need to delay its IPO or engage a new auditor in order to comply with the auditor independence rules, which would put it at a potential economic disadvantage when compared to an FPI. Several commenters specifically suggested that the definition of ''audit and professional engagement period'' be amended so that domestic issuers would be subject to the same audit and professional engagement period as FPIs when they are first filing, or are required to file, a registration statement or report with the Commission.[31] Commenters also suggested that shortening the look-back period may encourage capital formation for domestic issuers contemplating an IPO (*e.g.,* for those issuers that may have to delay an IPO to comply with Rule 2–01), or at least put them on the same footing as FPIs.[32]

In addition, 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 far back in time the prohibited service or relationship ended. If the prohibited service or relationship ended in the early years of the financial statements included in the initial registration statement, that fact may lend support to a conclusion that the auditor is objective and impartial under Rule 2–01 at the time the IPO is consummated.

In light of this feedback and our experience, we are proposing to amend Rule 2–01(f)(5)(iii) so that the one year look back provision for issuers filing or required to file a registration statement or report with the Commission for the first time (''first-time filers'') will apply to all such filers.[33] As proposed, an auditor for a first time filer that is either a domestic issuer or an FPI would apply Rule 2–01 for the most recently completed fiscal year included in its first filing 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. We believe that the proposed requirement to comply with applicable independence standards in all prior periods sufficiently mitigates the risk associated with shortening the look back provision for domestic first-time filers. Also, 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, such relationships and services should still be considered under the general standard of Rule 2–01(b). Similar to the discussion in Section II.A.1, for the relationships and services to be evaluated under Rule 2–01(b), individually and in the aggregate,

would apply here as well. *See* Section II.C.3 of the Loan Provision Adopting Release.

[29] *See* Preliminary Note 2 and paragraphs (c)(1), (2), (3), (4), and (5) to Rule 2–01.

[30] 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).

[31] *See e.g.,* letters from PwC, CAQ, BDO, AICPA, and AIC.

[32] *See e.g.,* letters from CAQ, AICPA, and AIC.

[33] The proposed amendments would not impact the compliance analysis related to the partner rotation provisions in Rule 2–01(c)(6).

we would expect those relationships and services would be easily known by the auditor as such services and relationships might be thought to reasonably bear on an auditor's independence due to the nature, extent, relative importance, or other aspects of the service or relationship.

Request for Comment

16. We are proposing to amend rule 2–01(f)(5) to shorten the look-back period for all first-time filers to the most recently completed fiscal year, which would result in treating all first-time filers (including domestic issuers and FPIs) similarly for purposes of our independence requirements under Rule 2–01. Should we amend Rule 2–01(f)(5) as proposed? Alternatively, should we consider instead lengthening the lookback period for FPIs to all periods in which the financial statements are being audited or reviewed to harmonize the lookback periods?

B. Proposed Amendments to Loans or Debtor-Creditor Relationships

Currently, under Rule 2–01(c)(1)(ii)(A) (the ''Loan Provision''), 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 loan) to or from an audit client, or certain other entities or persons related to the audit client.[34] The Commission originally adopted this provision because certain creditor or debtor relationships ''reasonably may be viewed as creating a self-interest that competes with the auditor's obligation to serve only investors' interest.''[35] Recognizing that not all creditor or debtor relationships threaten an auditor's objectivity and impartiality, the Commission included in Rule 2–01(c)(1)(ii)(A) a list of loans that are excepted from the prohibition. Under the current rule, the following loans from a financial institution under its normal lending procedures, terms, and requirements are excepted from the prohibition:

- Automobile loans and leases collateralized by the automobile;
- Loans fully collateralized by the cash surrender value of an insurance policy;
- Loans fully collateralized by cash deposits at the same financial institution; and
- 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.

Additionally, Rule 2–01(c)(1)(ii)(E) (the ''Credit Card Rule'') provides that 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 aggregated 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.

In response to the requests for comment in the Loan Provision Proposing Release, we received feedback suggesting other potential exceptions to the Loan Provision.[36]

1. Proposed Amendment To Except Student Loans

In the Loan Provision Proposing Release, we asked whether student loans should be excepted from the Loan Provision and received feedback supporting such exception.[37] In arriving at the proposed amendments, we considered the different characteristics associated with student loans, such as whether the student loan was obtained specifically for accounting and auditing education, obtained by the covered persons when they were pursuing their undergraduate education, or obtained by the covered persons for their immediate family members.

We propose to add 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 under Rule 2–01(f)(11). The limitation on the student loan exclusion (*i.e.,* not obtained while a covered person in the firm) is consistent with the current provision in Rule 2–01(c)(1)(ii)(A)(*1*)(*iv*) limiting the mortgage exclusion to mortgage loans ''not obtained while the covered person in the firm was a covered person,'' and provides a familiar principle for compliance purposes.

Moreover, we believe obtaining a student loan as a covered person poses a higher risk to the auditor's objectivity and impartiality because loans obtained while a covered person are likely more recent and thus may have a larger balance than loans obtained when such person was not a covered person. Additionally, a covered person obtaining a student loan from an audit client creates, at a minimum, an independence appearance issue that is not present when a non-covered person obtained a similar student loan from such audit client. In addition, the proposed exception would not encompass student loans obtained for a covered person's immediate family members. We are concerned 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. We are therefore limiting the exclusion to student loans obtained for the covered person's educational expenses. Considered together, we believe these proposed limitations appropriately balance the benefits of the proposed exception with its potential impact on the auditor's objectivity and impartiality.

Request for Comment

17. We are proposing to except student loans obtained for a covered person's educational expenses that were not obtained while the covered person in the firm was a covered person. Should we adopt this new exception as proposed? Should we limit the proposed exception to student loans not obtained while the covered person in the firm was a covered person and to student loans obtained only for the individual's educational expenses (*i.e.,* not the loans of immediate family members), as proposed?

18. Should all student loans be excepted from the application of the Loan Provision? Should the proposed exception include any other limitations, such as being limited only to the covered person's accounting and auditing educational expenses? Alternatively, should we expand the proposed exception to student loans of immediate family members? If we expand the exception to student loans of immediate family members, should we adopt a dollar limit on the aggregate amount of student loans that may be excepted? Is the overarching

[34] In the Loan Provision Adopting Release, the Commission amended this rule to replace ''record or beneficial owners of more than ten percent of the audit client's equity securities'' with beneficial owners known through reasonable inquiry that have ''significant influence over the audit client.'' The Commission also added new paragraphs (2)(i) and (ii) to Rule 2–01(c)(1)(ii)(A) to address how the amended rule applies to a fund that is an audit client.

[35] *Revision of the Commission's Auditor Independence Requirements,* Release No. 33–7870 (June 30, 2000) [65 FR 43147 (July 12, 2000)].

[36] *See e.g.,* letters from Grant Thornton LLP (July 9, 2018) (''Grant Thornton''), BDO, EY, RSM US LLP (July 9, 2018) (''RSM''), Financial Executives International (July 9, 2018) (''FEI''), MFS Funds Board Audit Committee (July 6, 2018) (''MFS Funds''), T. Rowe Price (July 9, 2018), and the Securities Industry and Financial Markets Association, Asset Management Group (July 9, 2018) (''SIFMA'').

[37] *See e.g.,* letters from Grant Thornton, BDO, EY, RSM, and FEI.

consideration of all relevant facts and circumstances related to the auditor's objectivity and impartiality, as required by Rule 2–01(b), sufficient to mitigate against any potential risk that student loans obtained for multiple immediate family members could be significant?

19. Should the proposed student loan exception include a limit on the amount that may be outstanding? If so, what is the appropriate amount?

2. Proposed Amendment To Clarify the Reference to ''a Mortgage Loan''

We are proposing to clarify that the reference to ''a mortgage loan'' in Rule 2–01(c)(1)(ii)(A)(*1*)(*iv*) was not intended to exclude just one outstanding mortgage loan on a borrower's primary residence. As currently drafted, the reference to ''a mortgage loan'' may be read to suggest that only a single loan would qualify for the exception. Over the years, the SEC staff has received questions about how the exclusion applies to second mortgages, home improvement loans, equity lines of credit, and similar mortgage obligations collateralized by a primary residence.[38] To provide further clarity on this point, we are proposing to revise Rule 2–01(c)(1)(ii)(A)(*1*)(*iv*) to refer to ''mortgage loans'' instead of ''a mortgage loan.''

Further, 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.[39]

Request for Comment

20. Should we revise Rule 2–01(c)(1)(ii)(A)(*1*)(*iv*) to refer to ''mortgage loans'' instead of ''mortgage loan,'' as proposed?

3. Proposed Amendment To Revise the Credit Card Rule To Refer to ''Consumer Loans''

We received feedback from commenters on the Loan Provision Proposing Release that certain de minimis financings and immaterial loans may not threaten an auditor's objectivity and impartiality.[40] We agree that a limited amount of debt that is routinely incurred for personal consumption, even if the audit client is the lending entity, would typically not impair an auditor's objectivity and impartiality. As such, we propose revising Rule 2–01(c)(1)(ii)(E) 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. Consistent with the payment terms in current Rule 2–01(c)(1)(ii)(E), 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. For example, if a covered person has an outstanding consumer loan balance above $10,000 with an audit client, such covered person would have to reduce the balance to $10,000 or less by the monthly due date, plus any available grace period, in order to comply with the proposed amendment. 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 retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence. We expect the types of consumer loans contemplated by the proposed amendment would typically have a payment due date consistent with credit cards (*e.g.,* monthly).

Request for Comment

21. We propose amending Rule 2–01(c)(1)(ii)(E) to replace ''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. Should we amend Rule 2–01(c)(1)(ii)(E), as proposed?

22. Is the outstanding balance limit of $10,000 appropriate? If not, what would be a more appropriate limit?

23. Is further guidance needed regarding how ''current basis'' applies for different types of consumer loans? If so, what additional guidance should we provide?

24. Is further guidance needed regarding the types of loans that would be considered ''consumer loans'' under the proposed amendment? If so, what additional guidance should we provide?

C. Proposed Amendment to the Business Relationships Rule

1. Proposed Amendment to the Reference to ''Substantial Stockholder''

Currently, Rule 2–01(c)(3) (the ''Business Relationships Rule'') 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 response to the Loan Provision Proposing Release, commenters suggested aligning this rule with the then proposed amendments to the Loan Provision by replacing the reference to substantial stockholders with a significant influence analysis.[41]

We agree 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 more clear and less complex. In this regard, we note that ''substantial stockholder'' is not currently defined in Regulation S–X, whereas the concept of significant influence is used in the Loan Provision[42] and other aspects of the independence rules.[43] As such, we recommend proposing to replace the term ''substantial stockholders'' in the Business Relationships Rule with the phrase ''beneficial owners (known

[38] *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 13, 2003) (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).

[39] *Id.*

[40] *See e.g.,* letters from Grant Thornton, Investment Company Institute and Independent Directors Council (July 9, 2018) (''ICI/IDC''), MFS Funds, T. Rowe Price, SIFMA, and Federated Investors, Inc. (July 10, 2018) (''Federated'').

[41] *See e.g.,* letters from Deloitte LLP (June 29, 2018) (''Deloitte''), PwC, KPMG LLP (July 3, 2018) (''KPMG''), Crowe LLP (July 3, 2018) (''Crowe''), CAQ, Professor Joseph A. Grundfest, Stanford Law School (July 9, 2018) (''Grundfest''), Grant Thornton, EY, U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (July 9, 2018) (''CCMC''), FEI, and AIC.

[42] Consistent with the recently adopted amendments discussed in the Loan Provision Adopting Release, the use of ''significant influence'' in these 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. Similarly, as it relates to the application of significant influence to investment companies, please refer to Section II.C.3 of the Loan Provision Adopting Release.

[43] *See e.g.,* Rule 2–01(f)(ii) and (iii).

through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client.''

2. Additional Guidance on the Reference to ''Audit Client'' When Referring to Persons Associated With the Audit Client in a Decision-Making Capacity, Including the Beneficial Owner With Significant Influence

The current Business Relationships Rule prohibits business relationships, in part, with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.[44] A commenter suggested that for this part of the Business Relationships Rule, the focus should be on those business relationships with persons in a decision-making capacity that are associated with the entity whose financial statements or other information is being audited, as opposed to the ''audit client'' more broadly which, by definition, includes affiliates of the audit client.[45] In other words, the commenter suggested the focus should be on those business relationships with persons in a decision-making capacity that are associated with the entity under audit.[46]

We agree that the focus should be on those business relationships with persons in a decision-making capacity as it relates to the entity under audit. In fact, our staff consultation experience regarding this portion of the Business Relationships Rule generally focuses on the persons associated with an affiliate of the audit client only where such persons would be able to exert decision-making capacity over the entity under audit. As such, as it relates to the proposed amendment discussed in the preceding section, 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, since business relationships with persons with such influence could be reasonably expected to impact an auditor's objectivity and impartiality.[47]

We are also providing this clarification based on recent staff experience with consultations concerning implementation of the recently amended Loan Provision. As noted in the preceding section, in June 2019 we adopted similar language for the Loan Provision to that being proposed as a replacement for ''substantial stockholders'' in this release (*i.e.,* ''beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client.'').[48] Staff consultations since the adoption of the amended Loan Provision are consistent with our past experience that, with regard to lending relationships with beneficial owners of equity securities of the audit client, including affiliates, the focus is on significant influence as it relates to the entity under audit when considering if the auditor's objectivity and impartiality is impaired.

As a result, the guidance in the second paragraph of this section also applies to the audit client references in the Loan Provision referring to ''an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client,'' as we believe that a threat to an auditor's objectivity and impartiality is more likely when the beneficial owner of the equity securities of the audit client, including affiliates, has significant influence over the entity under audit.

In summary, when an auditor is evaluating lending or business relationships with officers, directors, or beneficial owners with significant influence over an affiliate of the entity under audit pursuant to the Loan Provision or the current or proposed Business Relationships Rule, the auditor should focus on whether the significant influence exists at the entity under audit.

Request for Comment

25. Should we replace the reference to ''substantial stockholders'' in the Business Relationships Rule with the concept of beneficial owners with significant influence, as proposed? Would the proposed amendment make the rule more clear and reduce complexity, given that ''substantial stockholder'' is not currently defined in Regulation S–X? Alternatively, should substantial stockholder be defined? If so, how should we define it?

26. Would the proposed amendment result in more or fewer instances of business relationships that are prohibited by Rule 2–01(c)(3)? Does the concept of beneficial owners with significant influence, as proposed, more appropriately identify relationships that are likely to impair an auditor's objectivity and impartiality than the current rule?

27. We understand that it is more common today for companies to enter into multi-company arrangements in delivering products or services and that audit firms may contribute to such multi-company arrangements, such as through intellectual property or access to data using common technology platforms. Do these arrangements present instances where an auditor's objectivity and impartiality would not be impaired even after considering the proposed amendments discussed in this release? If so, what further amendments should be considered to appropriately focus on relationships where it is more likely an auditor's objectivity and impartiality would be impaired?

28. Is the guidance related to ''persons associated with the audit client in a decision-making capacity'' and its application to the amended Loan Provision appropriate? Is further guidance needed to assist auditors and their clients in applying the recently amended Loan Provision and the proposed amendments? If so, what additional guidance is needed? Should we codify this guidance in our rules?

D. Proposed Amendments for Inadvertent Violations for Mergers and Acquisitions

We understand from the staff's independence consultation experience that in certain instances an independence violation can arise as a result of a corporate event, such as a merger or acquisition, where the services or relationships that are the basis for the violation were not prohibited by applicable independence standards before the consummation of such corporate event.[49] For example, an audit firm could have an existing audit relationship with an issuer that acquires another company for which the audit firm was not the auditor but provided services or had relationships that would be prohibited under Rule 2–01. Through no action of the audit firm, the acquisition would cause what had been

[44] Rule 2–01(c)(3).

[45] *See* letter from AIC (July 26, 2019).

[46] As discussed in Section II.A.1, we refer to the entity whose financial statements or other information is being audited, reviewed, or attested, as the entity under audit.

[47] This guidance is limited to the analysis related to associated persons in a decision-making capacity of an audit client. This guidance does not change the analysis when evaluating ''any direct or material indirect business relationships with an audit client.'' Under the current and proposed rule, an auditor is still prohibited from having any direct or material indirect business relationships with an audit client, which includes any affiliates of the audit client.

[48] *See supra* note 7.

[49] In this section, we refer to these types of violations that only arise due to a corporate event, such as mergers and acquisitions, as ''inadvertent violations.''

permitted non-audit services or relationships to become prohibited non-audit services or relationships in violation of the auditor independence rules when the prohibited services or relationships occurred within the audit or professional engagement period as defined in Rule 2–01(f)(5). We also received comments in response to the Loan Provision Proposing Release suggesting that a transition framework should be available for inadvertent independence violations triggered by corporate events, such as IPOs and mergers and acquisitions.[50]

With respect to IPOs, we preliminarily believe the proposed amendments discussed in Section II.A.2 could significantly mitigate the challenges associated with these transactions because only one year of previous compliance with Rule 2–01 would be required. In an IPO, the auditor generally has an existing auditor-client relationship with the audit client and the IPO is generally contemplated well in advance of its consummation. As a result, focusing the independence analysis on the most recent preceding fiscal year should significantly mitigate the challenges associated with consummating an IPO under our rules.

We believe that the root cause of auditor independence issues arising from mergers and acquisitions, however, generally differs from that arising from IPOs. In situations involving mergers and acquisitions, a pre-existing auditor-client relationship between the auditor and the merged company or the company being acquired is less likely, as compared to an IPO, and the timing of the transaction is generally shorter and more uncertain. As such, these transactions can give rise to auditor independence violations that are inadvertent and often difficult to contemplate in advance.[51] The prospect of auditor independence issues arising as a result of a corporate acquisition transaction can have an adverse effect on the audit client, as it may result in the termination of audit work midstream or termination of the non-audit service that is in progress in a manner that is costly to the audit client.[52] Alternatively, it could result in a delay of a merger or acquisition while the auditor and its audit client attempt to resolve the potential independence matters to the possible detriment of the audit client and investors.[53] Accordingly, we believe it is appropriate to provide, in a manner that preserves investor protection, a transition framework for mergers and acquisitions to address inadvertent violations related to such transactions so the auditor and its audit client can transition out of prohibited services and relationships in an orderly manner.

As such, we are proposing amendments to Rule 2–01 to address the challenges discussed above that may result from a merger or acquisition. The proposed framework follows the consideration of the audit firm's quality controls similar to Rule 2–01(d).[54] Under the proposed amendments, the auditor must:

- 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;
- Have in place a quality control system as described in 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.

Regarding the first provision, the auditor must be in compliance with the independence standards 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 prior to the SEC and PCAOB independence standards applying as a result of such transaction.

With respect to correction of the independence violation as promptly as possible, our expectation is that the violation, in most instances, should and could be corrected before the effective date of the merger or acquisition. However, we understand in some situations it might not be possible for the audit client and the auditor to transition the prohibited non-audit service or relationship in an orderly manner without causing significant disruption to the audit client. In those situations, we would expect the relationship or service to be corrected as promptly as possible after the effective date of the merger or acquisition. Whether a post-transaction transition is considered ''as promptly as possible'' depends on all relevant facts and circumstances used to support the delayed correction. However, under the proposed transition framework, we expect all corrective action would be taken no later than six months after the effective date of the merger or acquisition that triggered the independence violation. Audit firms and audit clients already manage to this timeline as it is consistent with international ethical standards for accountants.[55]

Request for Comment

29. Should we provide the transition framework to address inadvertent independence violations arising from mergers and acquisitions, as proposed? Should we expand the proposed framework to encompass IPOs? If so, would this eliminate the need for the proposed amendments in Section II.A.2? If we expand the proposed framework to encompass IPOs, are there additional criteria we should include in the quality control requirement? Are there other transactions that should be covered by the proposed framework?

30. Are the proposed criteria for the quality control requirement sufficiently clear? If not, how could they be clarified?

31. Are there other criteria that should be added to the quality control requirement?

32. Should certain prohibited services and relationships continue to be an independence violation regardless of the transition framework such as if the

[50] *See e.g.,* letters from Deloitte, PwC, KPMG, Crowe, CAQ, Grundfest, Grant Thornton, BDO, EY, CCMC, FEI, AICPA, and AIC.

[51] Given that these violations arise out of relationships or services that were in place before the relationships or services became prohibited as a result of being subject to our independence requirements, the staff has generally not objected, as part of the independence consultation process, to the auditor and the audit client's determination that the auditor's objectivity and impartiality were not impaired in these circumstances.

[52] *See e.g.,* letters from Deloitte and Grundfest.

[53] *Id.*

[54] The Commission adopted 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.'' 2000 Adopting Release, at 65 FR 76052.

[55] *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.*

service or relationship results in the auditor auditing its own work?

33. The proposed framework requires any independence violations resulting from a merger or acquisition to be corrected as promptly as possible. What is a reasonable period of time after the consummation of a merger or acquisition that would allow for an auditor to correct most types of violations covered by the proposed framework? Should the proposed amendments specify a maximum period of time for such corrections?

34. Should we exclude certain types of merger and acquisition transactions from the proposed transition framework? If so, what transactions should be excluded? For example, should the framework exclude transactions that are in substance more like an IPO, such as when the acquirer is a public shell company? In these situations, would it be more appropriate to apply the proposed amendments related to the look-back period for IPOs?

E. Proposed Amendments for Miscellaneous Updates

1. Proposed Amendments To Update the Reference to Concurring Partner Within Rule 2–01

On August 17, 2018, the Commission updated a number of rules as part of its disclosure effectiveness initiative.[56] Prior to the adoption of these amendments, Rule 2–01(f)(7)(ii)(B) explained that the ''partner[s] performing a second level of review to provide additional assurance . . .'' are considered ''concurring or reviewing partners.''[57] In its recent amendments, the Commission revised the language in Rule 2–01(f)(7)(ii)(B) to be consistent with current auditing standards. As a result, the rule no longer uses the term ''concurring partner'' and instead uses the terms ''Engagement Quality Reviewer'' and ''Engagement Quality Control Reviewer'' to describe the ''partner conducting a quality review.'' As such, we propose conforming amendments throughout Rule 2–01 to replace references to ''concurring partner'' with the term ''Engagement Quality Reviewer.''

2. Proposed Amendment to Preliminary Note to Rule 2–01

We propose a technical amendment to convert the current Preliminary Note to Rule 2–01 into introductory text to Rule 2–01, as this is consistent with current **Federal Register** practices. This proposed amendment is in no way intended to affect the application of the auditor independence rules.

3. Proposed Amendment To Delete Outdated Transition and Grandfathering Provision

Rule 2–01(e) was added as part of the 2003 amendments discussed in Section I to address the existence of relationships and arrangements that predated those amendments.[58] Based on the passage of time, these transition and grandfathering provisions are no longer necessary. We propose deleting the current Rule 2–01(e) and reserving it for the proposed amendments discussed in Section II.D.

Request for Comment

35. Should we make the miscellaneous updates described above? Are there other conforming amendments we should make in light of these updates?

III. Economic Analysis

A. Introduction

We are proposing to amend the auditor independence requirements in Rule 2–01 by: (1) Amending the definition of an affiliate of an audit client to address certain affiliate relationships in common control scenarios and the definition of investment company complex; (2) shortening the look-back period for domestic first time filers in assessing compliance with the independence requirements; (3) adding certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships; (4) replacing the reference to ''substantial stockholders'' in the Business Relationships Rule with the concept of beneficial owners with significant influence; and (5) introducing a transition framework for merger and acquisition transactions to consider whether an auditor's independence is impaired, among other updates.

We are sensitive to the costs and benefits of the proposed amendments. The discussion below addresses the potential economic effects of the proposed amendments, including the likely benefits and costs, as well as the likely effects on efficiency, competition, and capital formation.[59]

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 proposed 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 selected aspects of the auditor independence rules and the potential compliance cost savings and changes in audit quality that may arise from the proposed amendments to Rule 2–01.

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

B. Baseline and Affected Parties

The proposed amendments would update the auditor independence requirements, which would impact 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 proposed amendments include ''covered persons'' of accounting firms and their immediate family members. As discussed further below, the proposed amendments are likely to affect investors indirectly.

We are not able to estimate precisely the number of current audit engagements that would be immediately affected by the proposed amendments. We also do not have precise data on audit clients' ownership and control structure. With respect to the proposed 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 data readily available to quantify the number of business relationships that audit firms have with beneficial owners of an

[56] *Disclosure Update and Simplification,* Release No. 33–10532 (Aug. 17, 2018) [83 FR 50148 (Oct. 4, 2018)].

[57] *See* 2018 Annual Edition of the Code of Federal Regulations, 17 CFR 210.2–01, *available at https://www.govinfo.gov/content/pkg/CFR-2018-title17-vol3/pdf/CFR-2018-title17-vol3-part210.pdf.*

[58] *See supra* note 6.

[59] 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.

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 proposed amendments to the Business Relationships Rule. We therefore are not able to quantify the effects of these aspects of the proposed amendments.

We have relied on information from PCAOB Forms 2 to approximate the potential universe of auditors that may be impacted by the proposed amendments.[60] According to aggregated information from PCAOB Forms 2, as of December 31, 2018, there were 1,862 audit firms registered with the PCAOB (of which 984 are domestic audit firms, with the remaining 878 audit firms located outside the United States). According to a report provided by Audit Analytics in 2018, the four largest accounting firms audit about 75 percent of accelerated and large accelerated filers[61] and about 46 percent of all registrants.[62]

We estimate that approximately 6,919 issuers filing on domestic forms[63] and 393 FPIs filing on foreign forms would be affected by the proposed amendments.[64] Among the issuers that file on domestic forms, approximately 29 percent are large accelerated filers, 19 percent are accelerated filers, 19 percent are non-accelerated filers, and 33 percent are smaller reporting companies.[65] In addition, we estimate that approximately 21.3 percent of domestic issuers are emerging growth companies.[66]

The proposed amendment related to the ''look-back'' period for assessing independence compliance would impact 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 421 domestic IPOs during the period between June 30, 2016, and June 30, 2019.

The proposed amendment related to a transition framework for merger and acquisition transactions would impact issuers that might engage in mergers and acquisitions at some point in time. To assess the overall market activity for mergers and acquisitions, we examined mergers and acquisitions data from SDC. During the period from January 1, 2016, to December 31, 2018, there were 6,310 mergers and acquisitions entered into by publicly listed U.S. firms.

The proposed amendments to the ICC definition would potentially affect registered investment companies and unregistered funds.[67] We estimate that there were 3,160 registered investment companies with an ''Active'' status as of December 2018. As of September 2019, there were 10,201 mutual funds (including money market funds) with $24,725 billion in total net assets, 1,918 ETFs with $3,455 billion in total net assets, 666 UITs (excluding ETFs) with $1,509 billion in total net assets, 664 registered closed-end funds with $294 billion in total net assets, and 13 variable annuity separate accounts registered as management investment companies on Form N–3 with $224 billion in total net assets.[68] In addition, as of June 2019, there were 99 BDCs with $63 billion in total net assets.[69]

C. Potential Costs and Benefits

In this section, we discuss the anticipated economic benefits and costs of the proposed amendments. We first analyze the overall economic effects of the proposed amendments. We then discuss the potential costs and benefits of specific proposed amendments.

1. Overall Potential Benefits and Costs

We anticipate the proposed amendments would benefit audit firms and audit clients in several ways. First, the proposal is likely to reduce compliance costs for both audit firms and their clients by updating certain aspects of the auditor independence requirements that may be unduly burdensome. The proposed amendments may reduce the emphasis in our rules on relationships and services that are less likely to threaten auditor objectivity and impartiality. As a result, the proposed amendments likely would allow auditors and audit clients to focus their resources and attention on those relationships and services that are more likely to pose threats to auditor objectivity and impartiality. In turn, compliance costs likely would decrease for both auditors and audit clients.

A reduction in compliance costs also may be realized because of the potential larger pool of eligible auditors due to the proposed amendments. With a larger pool of eligible auditors, audit clients could potentially avoid costs associated with searching for an independent auditor and related costs resulting from switching from one audit firm to

[60] All registered 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.

[61] Accelerated filers and large accelerated filers are defined in Rule 12b–2 of the Exchange Act of 1934 [17 CFR 240.12b-2].

[62] *See Who Audits Public Companies-2018 Edition, available at https://blog.auditanalytics.com/who-audits-public-companies-2018-edition.*

[63] This number includes fewer than 25 foreign issuers that file on domestic forms and approximately 100 business development companies.

[64] 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 and 10–Q, or an amendment thereto, with the Commission during calendar year 2018. We believe that these filers are representative of the issuers that would primarily be affected by the proposed amendments. For purposes of this economic analysis, these estimates do not include issuers that filed only initial domestic Securities Act registration statements during calendar year 2018, and no Exchange Act reports, in order to avoid including entities, such as certain co-registrants of debt securities, which may not have independent reporting obligations and therefore would not be affected by the proposed amendments. Nevertheless, the proposed amendments would affect any registrant that files a Securities Act registration statement and assumes Exchange Act reporting obligations. We believe that most registrants that have filed a Securities Act registration statement, other than the co-registrants described above, would be captured by this estimate through their Form 10–K and Form 10–Q filings. 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.

[65] ''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.

[66] 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.

[67] 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 proposed amendments.

[68] 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 September 5, 2019. For open-end funds that have mutual fund and ETF share classes, 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.

[69] 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 June 30, 2019. Our estimate includes BDCs that may be delinquent or have filed extensions for their filings, and it excludes 6 wholly owned subsidiaries of other BDCs.

another. Larger pools of potentially qualified independent auditors may promote competition among audit firms, which may lower audit fees. Reduction in audit fees would lead to cash savings for audit clients, who could utilize the savings to make further investments or return excess savings to investors, all which may accrue to the benefit of investors. However, this competition effect may be limited because the audit industry is highly concentrated [70] with the four largest audit firms auditing about 46 percent of all registrants. More specifically, the four largest audit firms audit about 75 percent of accelerated and large accelerated filers.[71]

The potential expansion of auditor choices as a result of the proposed amendments could also allow audit clients to align audit expertise better with the audit engagement, which may lead to an improvement in audit quality and financial statement quality.[72] For example, audit clients in certain industries might have more complicated or very specialized businesses, requiring auditors of those clients to possess certain expertise or experience. If the pool of potential independent auditors is restricted due to prohibitions under current Rule 2–01 that are the subject of the proposed amendments, an audit client might have to choose what it regards as a ''suboptimal'' audit firm, which may not provide the highest quality audit services. Since audit quality is correlated with financial reporting quality,[73] the improved financial reporting quality under the proposed amendments also would benefit audit clients as the higher quality of financial reporting could potentially reduce information asymmetry between auditors and their investors, improve firms' liquidity and decrease cost of capital.[74] Investors would similarly benefit from any resulting improvement in financial reporting quality.

Auditors also could benefit from the proposed amendments as they may have a broader spectrum of audit clients and clients for non-audit services. If the proposed amendments reduce certain burdensome constraints on auditors in complying with the independence requirements, auditors likely would incur fewer compliance costs. In addition, the proposed amendments could potentially reduce auditor turnover due to changes in audit clients' organizational structure arising from certain merger and acquisition activities. The proposal may also benefit auditors that provide non-auditing services, as those audit firms, under the proposed amendments, would be permitted to provide such services to an entity that is under common control with the audit client, so long as that entity is not material to the controlling entity.

There also could be certain costs associated with the proposed amendments. For example, if the proposed amendments increase the risk of auditors' objectivity and impartiality being threatened by newly permissible relationships and services, investors could have less confidence in the quality of financial reporting, which could lead to less efficient investment allocations and increased cost of capital. Overall, however, we do not anticipate significant costs to investors or other market participants associated with the proposal because the proposed amendments address those relationships and services that are less likely to threaten auditors' objectivity and impartiality.

2. Benefits and Costs of Specific Proposed Amendments

We expect the proposed amendments would 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.

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

i. Affiliate of the Audit Client

Currently, the term affiliate of the audit client includes not only ''an entity that has control over the audit client or over which the audit client has control,'' but also those ''*under common control with the audit client, including the audit client's parents and subsidiaries*'' [75] (emphasis added). Under this definition, affiliates of the audit client include all entities under common control with the audit client, including those that are not 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 with complex organizational structures. As it relates to entities under common control, the proposed amendment includes as affiliates of the audit client only sister entities that are material to the controlling entity for the auditor independence analyses. Excluding sister entities that are not material to the controlling entity likely would reduce compliance costs associated with having to consider and potentially monitor independence impairing relationships and services involving such entities.[76] The proposed amendment also would help avoid the costs that audit clients could incur to switch auditors. Additionally, the proposed amendment could reduce instances of lost revenues from non-audit services (*e.g.,* management functions) that auditors must give up where an independence impairing relationship or service exists with a sister entity that is not material to the controlling entity. These cost savings could be especially pronounced for entities with complex organizational structures (*e.g.,* private equity structures) that have an expansive and constantly changing list of affiliates because the proposal may significantly reduce the number of entities that fall within the definition of affiliates of the audit client.

According to the current definition of affiliate of the audit client, an auditor

[70] *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* (2008).

[71] *See supra* note 62.

[72] *See* Mark Defond and Jieying Zhang, A Review of Archival Auditing Research, 58 J. Acct. Econ. 275 (2014).

[73] *See id.*

[74] *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.

[75] Rule 2–01(f)(4)(i).

[76] As noted in Section II.A above, notwithstanding the proposed amendments, auditors and their clients would continue to be required to consider ''all relevant facts and circumstances,'' consistent with the general independence standard in Rule 2–01(b). Thus, audit firms and their clients may continue to incur some costs to consider such entities as part of their independence analysis. However, for those relationships and services that might nevertheless impact the auditor's independence under the general standard in Rule 2–01(b), we would expect those relationships and services individually or in the aggregate would be easily known by the auditor and the audit client because such services and relationships might be thought to reasonably bear on an auditor's independence due to the nature, extent, relative importance or other aspects of the service or relationship. We note that a similar qualification applies with respect to other aspects of the proposed amendments that could have the potential benefit of reducing compliance costs associated with considering and monitoring independence impairing relationships and services.

with desired expertise may be excluded from a firm's audit engagement consideration because the auditor currently provides management functions for the firm's sister entity that is not material to the controlling entity. The exclusion of certain specialized auditors from an audit engagement due to their prohibited relationships or services with a sister entity that is not material to the sister entity under the current rule might lead to the audit engagement not being matched with the most qualified auditors. Such an outcome could compromise the audit quality and decrease financial reporting quality, thereby imposing compliance costs on audit clients and investors. In addition, the lack of matching between auditor expertise and audit tasks might result in inefficiency in the auditing processes, which likely increases the costs of audit services (*e.g.,* audit fees).

The proposed amendment to the 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.[77] However, the auditor market is highly concentrated, and such cost savings are likely to be limited. The expanded pool of qualified auditors also might improve matching between auditor expertise and audit task, thereby improving audit efficiency and reducing audit costs.[78] Furthermore, the proposed amendment might positively influence audit quality and financial reporting quality through improved auditor-client alignment.[79]

The proposed amendments are likely to benefit investors indirectly. First, the potentially expanded auditor choices under the proposed amendment might improve audit quality through better matching between auditor expertise and audit engagement, thus potentially enhancing financial reporting quality.[80] Better financial reporting quality would help 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 might be passed to investors.

The proposed ''materiality test'' in the amended definition of audit client might require more efforts from audit firms and audit clients to familiarize themselves with and to apply the test. This might potentially increase the compliance costs. However, given that the materiality concept is already part of the Commission's auditor independence rules,[81] we do not expect a significant learning curve in applying the test or significant incremental compliance costs for auditors.

ii. Investment Company Complex

As discussed in Section II.A.1.b, above, the proposed amendments (1) direct auditors of an investment company or an investment adviser or sponsor to include all entities within the proposed ICC definition as affiliates of the audit client; (2) focus the ICC definition from the perspective of the entity under audit; (3) include within the meaning of the term investment company, for the purposes of the ICC definition, unregistered funds; (4) amend the common control prong of the ICC definition to include only sister investment companies, advisers, and sponsors that are material to the controlling entity; and (5) include within the ICC definition entities where significant influence exists between those entities and an audit client.

The proposed amendments to the ICC definition would impact 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 proposal would lead to improved clarity in the ICC definition and, for the purpose of auditor independence analysis, could facilitate audit firms, registered investment companies, unregistered funds, and investment advisors or sponsors in complying with the auditor independence requirements. The improved clarity under the amended definition may result in compliance cost savings, thus benefiting audit firms and audit clients.

The economic implications of the materiality test under the amended definition of investment company complex are largely similar to those for operating companies as discussed above. For example, under the current ICC definition, an investment company audit client may have a rather restricted set of independence compliant auditors due to the current common control provisions. The proposed amendments could potentially reduce compliance costs for investment company audit clients because the proposed ICC definition excludes from the affiliate analysis sister entities that are not material to the controlling entity.

In addition, the auditors with certain relationships or providing certain non-audit services to sister entities that are not material to the controlling entity may become eligible to serve as an auditor to the audit client under the proposed amendments. The potential expanded pool of compliant auditors could help registered investment companies and unregistered funds hire (and retain) auditors who have more relevant industry expertise, which potentially 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 respect to the proposed amendments that include unregistered funds within the meaning of the term investment company, for purposes of the ICC definition,[82] we believe the proposed amendments provide a useful update to the ICC definition that was adopted in 2000. Specifically, we believe the proposed amendments provide clarity for unregistered funds, their investment advisers or sponsors, and their auditors. In addition to this clarity, defining investment company to include unregistered funds would 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, would not be subject to

[77] *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).

[78] The proposed amendments could result in some crowding-out effect, as the four largest audit firms may be deemed to be independent with more clients under the proposed amendments, 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.

[79] *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 Realignments 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).

[80] *See supra* note 72.

[81] *See e.g.,* Rule 2–01(f)(4)(ii) and (iii).

[82] *See* proposed Rule 2–01(f)(14)(iv).

disparate application of the independence rules.

We do not anticipate significant incremental costs associated with the proposed amendments to the ICC definition for registered investment companies, unregistered funds, investment advisers or sponsors, or auditors as well as investment company investors. The proposed amendments may require additional effort from audit firms and registered investment companies, unregistered funds, and investment advisers or sponsors that are under audit to become familiar with the application of the proposed ICC definition. This may potentially lead to an initial increase in compliance costs. However, the proposed amendments would improve the clarity of the ICC definition and therefore likely would decrease overall compliance costs after affected parties adjust to the new definition. The proposed materiality test is already part of the Commission's auditor independence rules [83] and also is aligned with the proposed common control prong of the affiliate of the audit client definition.[84] Therefore, we do not expect a significant learning curve in applying the test or significant incremental compliance costs for auditors or registered investment companies, unregistered funds, and investment advisers or sponsors.

We do not expect any significant economic effects associated with amending the definition of ICC to include the concept of ''significant influence.'' As discussed in Section II.A.1.b.iv above, audit clients and auditors are familiar with the concept as a result of the application of current Rule 2–01(f)(4)(ii) and (iii). The proposed amendment simply would align the ICC definition with the existing definition of affiliate of the audit client. Consistent with an auditor of an operating company, auditors of investment companies and investment advisers or sponsors who, under the proposed amendments, are directed to look solely to proposed Rule 2–01(f)(14), would be required to consider significant influence when identifying affiliates of the audit client.

b. Proposed Amendment to ''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.[85] A domestic IPO registration statement must include either two or three years of audited financial statements, and auditors of domestic first time filers need to comply with Rule 2–01 for all audited financial statement periods included in the registration statement.[86] 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 less well-qualified 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 propose to amend the definition such that the one-year look-back provision applies to all first time filers, domestic and foreign.

The proposed amendment to the definition of ''audit and professional engagement period'' would require domestic first time filers to assess auditor independence over a shortened look-back period (*i.e.,* a single immediate preceding year). The proposed change likely would alleviate the compliance challenges noted above for both domestic first time filers and their auditors. As a result, this proposed amendment could help domestic firms avoid the compliance costs associated with switching auditors or delaying the filing of an initial registration statement. These reduced compliance costs may facilitate additional domestic IPOs and thereby promote efficiency and capital formation.

This proposed 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.[87] Specifically, where an audit client is looking to potentially change auditors, an audit client would be able to select from a broader group of auditors to perform audit services related to the audit client's IPO even if the auditor had provided prohibited services or had prohibited relationships in the second or third year prior to filing the IPO. However, the audit industry is already highly concentrated, especially with respect to IPOs,[88] and consequently, such a benefit may not be significant. The expanded pool of qualified auditors 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 would positively influence audit and financial reporting quality, thereby benefiting investors and improving market efficiency.[89]

The proposed 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 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 committee and underwriters) in place at first time filers, and auditors are subject to heightened litigation risk around IPOs.[90]

c. Proposed Amendments to Loans or Debtor-Creditor Relationships

Currently, Rule 2–01 prohibits certain loans/debtor-creditor relationship and other financial interests with a few exceptions.[91] Commenter feedback from the Loan Provision Proposing Release supported certain additional exceptions

[83] *See e.g.,* Rule 2–01(f)(4)(ii) and (iii).

[84] *See* Proposed Rule 2–01(f)(4)(i)(B).

[85] *See* Section II.A.2.

[86] For example, a specialized auditor may be excluded from consideration if the auditor provided a prohibited 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.

[87] *See supra* note 77.

[88] *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. 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). They show that 84.2% of IPO firms of their sample use Big 4 auditors before going public.

[89] *See supra* note 79 and accompanying text.

[90] *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.

[91] Rule 2–01(c)(1)(ii).

(or exclusions) for these otherwise prohibited financial interests. As a result, the proposed amendments would make the following additional changes: (1) Include, as part of the exceptions, student loans for a covered person's educational expenses as long as the loan was obtained while the individual was not a covered person, and (2) update 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 proposed amendments to except certain student and consumer loans that are less likely to raise threats to auditors' objectivity or impartiality may alleviate some compliance burdens. For instance, audit firms would no longer have to monitor such student and consumer loans as part of their compliance program. The proposed amendments would permit certain covered persons (including audit partners and staff) to be considered independent notwithstanding the existence of certain lending relationships, such as student loans or consumer loans. 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 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.[92] Since audit quality improvement increases financial reporting quality, this benefit likely would accrue to the overall investment community.[93] Finally, the proposed amendments likely would make it easier for covered persons and their immediate family members to obtain necessary consumer loans, as they would no longer need to be concerned about such loans categorically being deemed as independence impairing.

The exclusion of previously prohibited financial obligations may increase the likelihood that some covered persons may participate in an audit of a client even when the covered persons or their family members have some financial relationships with the audit client, or an audit client's officers, directors, or beneficial owners. However, we do not believe student loans obtained by covered persons prior to being a covered person or de minimis consumer loans are likely to threaten an auditor's objectivity and impartiality.

d. Proposed Amendments to the Reference to ''Substantial Stockholder'' in the Business Relationships Rule

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.'' [94] 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 proposed amendment would 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 audit client'' to align this rule with changes recently made to the Loan Provision. The proposed 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,[95] and we do not expect a significant learning curve in applying the test for auditors and registrants.

e. Proposed Amendments for Inadvertent Violations for Mergers and Acquisitions

Currently, 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. As a result, certain merger and acquisition transactions could give rise to inadvertent violations of 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. 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 is likely not impaired.[96]

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 potentially value-enhancing transactions altogether, or (iii) switch auditors or stop the prohibited relationships or services mid-stream, potentially resulting in disruption to the registrant.

We are proposing amendments to Rule 2–01 to establish a transition framework for mergers and acquisitions to address these costs. Under the proposed amendments, auditors and their audit clients would be able to transition out of prohibited relationships or services in an orderly manner in certain situations. As such, the proposed amendments likely would reduce registrants' independence 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 proposed transition framework would allow, in certain situations, up to six months after the transaction effective date to correct the prohibited relationship or service. As a result, the proposed framework would help registrants, especially those entities with complex organizational structures and those actively pursuing merger and acquisition transactions, to achieve full and timely compliance 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 transitional costs to auditors and audits clients as they adapt to the proposed framework. However, given that the framework follows the consideration of the audit firm's quality controls similar to existing Rule 2–

[92] *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.

[93] *See supra* note 74 and accompanying text.

[94] *See* Rule 2–01(c)(3).

[95] *See e.g.,* Rule 2–01(f)(4)(ii) and (iii).

[96] *See supra* note 51.

01(d), we do not expect a significant learning curve in applying the proposed framework for auditors and audit clients. The proposed 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 certain 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 proposed amendments likely would 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.

The proposed 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 proposed amendments are expected to expand the pool of eligible auditors and covered persons to undertake audit engagements without impairing auditors' independence. As a result, audit clients should have more options and audit costs may decrease. The potential expansion of eligible auditing service providers may also lead to better alignment between the audit client's needs and the auditor's expertise. The improved alignment between auditor specialties and audit clients could enable auditors to perform auditing services more efficiently and effectively, thus potentially reducing audit fees and increasing audit quality over the long term.

The proposed amendments deemphasize relationships and services that are unlikely to threaten auditor objectivity and impartiality, 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 proposed amendments do so, the quality of financial reporting is likely to improve, and the amount of audit client audit committee attention to independence questions when objectivity and impartiality is not at issue will be reduced, thus allowing the board to focus on its 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 cost of capital, facilitate capital formation and improve overall market efficiency.[97]

The proposed amendments also may lead to changes in the competitive structure of the audit industry. We expect more accounting firms to be eligible to provide auditing services and be in compliance with proposed Rule 2–01. If the larger audit firms are the ones more likely to engage in non-audit relationships and services, and therefore, are more likely not to be in compliance with the existing Rule 2–01, then these firms are more likely to be positively affected by the proposed amendments. In particular, these firms may be able to compete for or retain a larger pool of audit clients. At the same time, the larger firms' potentially increased ability to compete for audit clients could potentially crowd out the auditing business of smaller audit firms. However, we estimate that the four largest accounting firms already perform 46 percent of audits for all registrants (or about 75 percent of accelerated and large accelerated filers) and more than 80 percent in the registered investment company space.[98] As a result, we do not expect any potential change in the competitive dynamics among auditor firms to be significant.

E. Alternatives

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

The proposed amendments would exclude certain student loans of a covered person that were obtained prior to the individual becoming a covered person in the audit firm from consideration as part of the independence analysis, as such loans are less likely to influence an auditor's objectivity and impartiality. The proposed exclusion, however, would not encompass student loans to immediate family members of the covered person. An alternative approach would be to exclude all student loans of a covered person and the individual's immediate family members obtained before the individual became a covered person. Student loans for immediate family members are individually similar to those for the covered person and may be less likely to pose threats to the objectivity or impartiality of the covered person. Excluding such loans could further address auditors' constraints when seeking to maintain compliance with the auditor independence requirements. However, when all student loans of the covered person's immediate family members are considered, the aggregated amount could be significant and, as a result, excluding such loans could increase threats to the covered person's independence.

Another alternative to the 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 better capturing 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 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.

The proposed transition framework for merger and acquisition transactions includes a provision that in certain situations allows affected auditors and audit clients up to six months following the completion of the transaction to promptly correct the prohibited relationship or service. An alternative approach would be to require correction 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 compliance analysis immediately following the

[97] *See supra* note 74. *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.

[98] *See supra* note 71. 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. These audit services were very concentrated, as 86% of the funds were audited by the four largest accounting firms.

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 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.

Finally, an alternative approach to shortening the look-back period for domestic first time filers would be to increase the look-back period for foreign 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 foreign first time filers and reduce the likelihood of potential independence impairing relationships and services, it would increase compliance burdens for foreign first time issuers and thus may reduce the incentives for the foreign first time filers to list in the United States, thereby impeding capital formation and limiting investment opportunities for U.S. investors.

F. Request for Comment

We request comment on all aspects of our economic analysis, including the potential costs and benefits of the proposed amendments and alternatives thereto, and whether the rules, if adopted, would promote efficiency, competition, and capital formation or have an impact on investor protection. Commenters are requested to provide empirical data, estimation methodologies, and other factual support for their views, in particular, on costs and benefits estimates.

IV. Paperwork Reduction Act

The amendments we are proposing do not impose any new ''collections of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA''),[99] nor do they create any new filing, reporting, recordkeeping, or disclosure requirements. Accordingly, we are not submitting the proposed amendments to the Office of Management and Budget for review in accordance with the PRA.[100] We request comment on whether our conclusion that the proposed amendments would not impose any new collections of information is correct.

[99] 44 U.S.C. 3501 *et seq.*

[100] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

V. Initial Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (''RFA'') [101] requires the Commission, in promulgating rules under section 553 of the Administrative Procedure Act,[102] to consider the impact of those rules on small entities. We have prepared this Initial Regulatory Flexibility Act Analysis (''IRFA'') in accordance with 5 U.S.C. 603. This IRFA relates to the proposed amendments to Rule 2–01 of Regulation S–X.

A. Reasons for and Objectives of the Proposed Action

As discussed above, the primary reason for, and objective of, the proposed amendments is to update certain provisions within the Commission's auditor independence rules to more effectively focus the analysis on those relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality. Specifically, the proposed amendments would:

- 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 relationship 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 updates.

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

B. Legal Basis

We are proposing the amendments pursuant to 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, and Sections 203 and 211 of the Investment Advisers Act.

[101] 5 U.S.C. 601 *et seq.*

[102] 5 U.S.C. 553.

C. Small Entities Subject to the Proposed Rules

The proposed amendments would 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.'' [103] 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. Securities Act Rule 157 [104] and Exchange Act Rule 0–10(a) [105] 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, 2018, there are approximately 1,173 issuers, other than registered investment companies, that may be small entities subject to the proposed amendments.[106] The proposed amendments would 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 proposed amendments would 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.[107] Commission staff estimates that, as of June 2019, approximately 42 registered open-end mutual funds, 8 registered ETFs, 33 registered closed-end funds, and 16 BDCs (collectively, 99 funds) are small entities.[108]

[103] 5 U.S.C. 601(6).

[104] 17 CFR 230.157.

[105] 17 CFR 240.0–10(a).

[106] 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, 2018, to December 31, 2018. The analysis is based on data from XBRL filings, Compustat, and Ives Group Audit Analytics.

[107] 17 CFR 270.0–10(a).

[108] This estimate is derived an analysis of data obtained from Morningstar Direct as well as data

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.[109]

We estimate, as June 30, 2019, that there are approximately 470 investment advisers that would be subject to the proposed amendments that may be considered small entities.[110]

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 Rule 17a–5(d) under the Exchange Act,[111] 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.[112] As of December 31, 2018, there are approximately 985 small entity broker-dealers that will be subject to the final amendments.[113]

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.[114] 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 revenue. We request comment on the number of accounting firms with revenue under $20.5 million.

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments would not impose any reporting, recordkeeping, or disclosure requirements. The proposed amendments would impose new compliance requirements with respect to Rule 2–01.

With respect to the proposed amendments related to student loans, consumer loans, and the definition of the audit and engagement period for first time filers, we believe that such proposed amendments would not increase costs for smaller entities, including smaller accounting firms. With respect to the proposed amendments related to the definitions of affiliate of the audit client and ICC, the proposed amendments should serve to reduce, if at all, the number of entities that are deemed affiliates of the audit client. As such, any additional compliance effort related to the revised definitions would be offset by the less restrictive nature of the proposed definition as compared to the current definition.

With respect to the proposed amendment adding a merger and acquisition transition framework, there would be a new compliance burden only if the auditor and its client seek to avail themselves of the framework. As such, any additional compliance effort would be offset in any circumstance where relationships and services prohibited under the current rule would be deemed not to impair independence under the proposed amendments.

Regarding the amendment to the Business Relationship 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.[115] As such, we believe that affected entities likely would be able to leverage any existing practices, processes or controls to comply with the proposed amendments compared to having separate compliance requirements by retaining the reference to substantial stockholder.

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

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe that the proposed amendments would not duplicate, overlap or conflict with other Federal rules.

F. Significant Alternatives

The RFA directs us to consider alternatives that would accomplish our stated objectives while minimizing any significant adverse impacts on small entities. In connection with the proposed amendments, we considered certain types of alternatives, including:

(1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities;

(2) The clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities;

(3) The use of performance rather than design standards; and

(4) An exemption from coverage of the rule, or any part of the rule, for small entities.

In connection with our proposed 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 proposed amendments are designed to address compliance challenges for both large and small audit clients and audit firms. With respect to clarification, consolidation or simplification of compliance and reporting requirements for small entities, the proposed amendments do not contain any new reporting requirements.

While the proposed amendments establishing a materiality test for common control in the affiliate of the audit client definition, amending the ICC definition, providing a transition framework for mergers and acquisitions, and using a ''significant influence'' test in the Business Relationships Rule would create new compliance requirements, these proposed amendments are meant to better identify those relationships and services that could 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 current rule. The flexibility that could result from the proposed amendments

reported to the Commission for the period ending June 2019.

[109] 17 CFR 275.0–7.

[110] This estimate is based on SEC registered investment adviser responses to Item 12 of Form ADV.

[111] 17 CFR 240.17a–5(d).

[112] 17 CFR 240.0–10(c).

[113] This estimate is based on 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.

[114] 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.

[115] *See supra* note 7.

would be applicable to all affected entities, regardless of size.

With respect to using performance rather than design standards, we note that several of the proposed amendments are more akin to performance standards. Rather than prescribe the specific steps necessary to apply such standards, the proposed 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 proposed 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 would accommodate entities of various sizes while potentially avoiding overly burdensome methods that may be ill-suited or unnecessary given the facts and circumstances.

The proposed amendments are intended to update the independence rules to reflect recent feedback received from the public and our 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. In this respect, exempting small entities from the proposed amendments would increase, rather than decrease, their regulatory burden relative to larger entities.

G. Solicitation of Comment

We encourage the submission of comments with respect to any aspect of this IRFA. In particular, we request comments regarding:

- The number of small entities that may be subject to the proposed amendments;
- The existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis;
- 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.

Respondents are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments.

VI. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA''),[116] the Commission must advise the Office of Management and Budget as to whether a proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' when, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

If a rule is ''major,'' its effectiveness generally will be delayed for 60 days pending Congressional review.

We request comment on whether our proposed amendments would be a ''major rule'' for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment or innovation.

We request those submitting comments to provide empirical data and other factual support for their views to the extent possible.

VII. Statutory Basis

The proposed amendments described in this release are being proposed 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, and Sections 203 and 211 of the Investment Advisers Act of 1940.

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 proposes to amend title 17, chapter II of the Code of Federal Regulations as follows:

[116] Public Law 104–121, Tit. II, 110 Stat. 857 (1996).

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, 78*l*, 78m, 78n, 78*o*(d), 78q, 78u–5, 78w, 78*ll,* 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)(*1*)(*iii*);
■ d. Revising paragraph (c)(1)(ii)(A)(*1*)(*iv*);
■ e. Adding paragraph (c)(1)(ii)(A)(*1*)(*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)(*1*);
■ k. Revising paragraph (c)(6)(i)(B)(*1*);
■ 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), to 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) * * *

(*1*) * * *

(*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 obtained for a covered person's educational expenses 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, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client. 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) * * *

(*1*) 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) * * *

(*1*) Within the five consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(*1*) 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:

(i) The accounting firm is 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;

(ii) The accounting firm's lack of independence under this rule has been or will be corrected as promptly as possible under relevant circumstances as a result of the occurrence of the merger or acquisition;

(iii) The accounting firm has in place a quality control system as described in Rule 2–01(d)(3) that has the following features:

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

(B) 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.

(f) * * *

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

(i) An entity:

(A) That has control over the audit client or over which the audit client has control, including the audit client's parents and subsidiaries;

(B) Which is under common control with the audit client, including the audit client's parents and subsidiaries, unless the entity is not material to the controlling entity;

(C) Over which the audit client has significant influence, unless the entity is not material to the audit client; and

(D) That has significant influence over the audit client, unless the audit client is not material to the entity; *or*

(ii) 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)(i)(C), (f)(4)(i)(D), or (f)(14)(i)(E) of this section.

* * * * *

(14) * * *

(i) * * *

(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 any investment adviser or sponsor identified in paragraph (f)(14)(i)(A)(*2*) or (B), or any investment company identified in paragraph (f)(14)(i)(A)(*1*), of this section;

(D) Any entity under common control with any investment company identified in paragraph (f)(14)(i)(A)(*1*) of this section, any investment adviser or sponsor identified in paragraph (f)(14)(i)(A)(*2*) or (B) of this section, or any entity identified in paragraph (f)(14)(i)(C) of this section; if the entity:

(*1*) Is an investment company, investment adviser or sponsor, unless the entity is not 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 in paragraphs (f)(14)(i)(A) through (f)(14)(i)(B);

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

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

(iv) An investment company, for purposes of paragraph (f)(14) of this section, means any investment company or 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. 80–a3(c)).

* * * * *

By the Commission.

Dated: December 30, 2019.

Vanessa A. Countryman,

Secretary.

[FR Doc. 2019–28476 Filed 1–14–20; 8:45 am]

BILLING CODE 8011–01–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 100

[Docket No. FR–6138–P–01]

RIN 2529–AA99

Fair Housing Act Design and Construction Requirements; Adoption of Additional Safe Harbors

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Proposed rule.

SUMMARY: This rule proposes to amend HUD's Fair Housing Act design and construction regulations by incorporating by reference the 2009 edition of International Code Council (ICC) Accessible and Usable Building and Facilities (ICC A117.1–2009) standard, as a safe harbor. The Accessible and Usable Buildings and Facilities standard is a technical standard for the design of facilities that are accessible to persons with disabilities. HUD proposes to determine that compliance with ICC A117.1–2009 satisfies the design and construction requirements of the Fair Housing Act and its amendments. This rule also proposes to designate the 2009, 2012, 2015 and 2018 editions of the International Building Code (IBC) as safe harbors under the Fair Housing Act. The IBC is a model building code and not law, but it has been adopted as law by various states and localities. The IBC provides minimum standards for public safety, health, and welfare as they are affected by building construction.

DATES: *Comment Due Date:* March 16, 2020.

ADDRESSES: Interested persons are invited to submit comments regarding this proposed rule to the Office of General Counsel, Rules Docket Clerk, Department of Housing and Urban Development, 451 Seventh Street SW, Room 10276, Washington, DC 20410–0500. Communications should refer to the above docket number and title.

Electronic Submission of Comments. Interested persons may submit comments electronically through the Federal eRulemaking Portal at *www.regulations.gov.* HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the *www.regulations.gov* website can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

No Facsimile Comments. Facsimile (FAX) comments are not acceptable. In all cases, communications must refer to the docket number and title.

Public Inspection of Public Comments. All comments and communications submitted to HUD will be available, without charge, for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Due to security measures at the HUD Headquarters building, an appointment to review the public comments must be scheduled in advance by calling the Regulations Division at 202–708–3055 (this is not a toll-free number). Hearing- or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service, toll-free at 800–877–8339. Copies of all comments submitted are available for inspection and downloading at *www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: Lynn Grosso, Director, Office of Enforcement, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street SW, Washington, DC 20410–2000; telephone number 202-708–2333 (this is not a toll-free number). Hearing- or speech-impaired individuals may access this number via TTY by calling the Federal Information Relay Service, toll-free, at 800–877–8339.

SUPPLEMENTARY INFORMATION:

I. Background

Title VIII of the Civil Rights Act of 1968, as amended, (42 U.S.C. 3601 *et seq.*) (the ''Fair Housing Act'' or ''Act'') prohibits discrimination in housing and housing-related transactions based on race, color, religion, national origin, sex, disability and familial status.[1] The Act

[1] The Fair Housing Act refers to people with ''handicaps.'' Subsequently, in the Americans with Disabilities Act of 1990 and other legislation, Congress adopted the term ''persons with disabilities'' or ''disability,'' which is the preferred usage. Accordingly, this document hereinafter uses the terms ''persons with disabilities,'' ''disability,''