CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
EXECUTIVE VICE PRESIDENT

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber.com

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Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: *Auditor Independence With Respect To Certain Loans or Debtor-Creditor Relationships (Release Nos. 33-10491; 34-83157; IC-33091; IA-4904; File No. S7-10-18; RIN 3235-AM01)*

Dear Mr. Fields:

The U. S. Chamber of Commerce (the "Chamber") created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.[1] The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. Auditor independence rules are an important part of this system and the CCMC appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") Proposal on *Auditor Independence With Respect to Certain Loan or Debtor-Creditor Relationships* to amend the auditor independence rules (the "Proposal" or "Proposed Amendments").

The CCMC has been a strong proponent of periodic review of existing regulations. Such reviews allow regulators to keep rules up to date and consistent with evolutions in our markets. Since the auditor independence rules were last substantially amended more than 15 years ago, the auditing profession has experienced consolidation and other structural changes that have transformed the industry in many fundamental ways. The myriad of relationships among audit firms

[1] The Chamber is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information.

and their many clients (and those clients' affiliates) have also become considerably more complicated.

In short, disqualification of an audit firm due to an inadvertent independence violation is a serious matter for issuers and their shareholders alike.

The Proposed Amendments would update the loan provisions in the auditor independence rules that are not functioning under current market conditions as intended when they were promulgated nearly two decades ago. The CCMC applauds the SEC for recognizing the need for this update and supports a focus on relationships that really matter for threats to an auditor's ability to exercise objective and impartial judgment.

CCMC also respectfully recommends the SEC undertake a holistic review of the auditor independence rule structure. Certain changes may be needed in order to reflect marketplace changes that have occurred since 2000.

Analysis of Proposed Amendments

The Proposal would amend portions of Rule 2-01(c)[2] of SEC Regulation S-X to reorient the analysis for determining auditor independence when an auditor[3] has a loan or debtor/creditor relationship with certain shareholders of the audit client at any time during an audit or professional engagement period. Specifically, the Proposed Amendments would:

- Focus the analysis solely on beneficial ownership rather than both record and beneficial ownership;
- Replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test;
- Add a "known through reasonable inquiry" standard in identifying beneficial owners of an audit client's equity securities; and

[2] For convenience, subsequent references are to Rule 2-01, rather than sections of the Rule.
[3] Throughout our letter the term "auditor" refers to both the accounting firm and its accountants, consistent with the SEC's auditor independence rules.

- Amend the definition of "audit client" for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client.[4]

The Proposed Amendments appear to address many of the issues and challenges that have arisen in regards to the loan provision of the auditor independence rules, although a few additional refinements may be appropriate. For example, while the CCMC supports removing record ownership from consideration, a materiality qualifier would maintain the focus on relationships that really matter. A materiality qualifier would provide that auditor independence would only be impaired as a result of certain relationships where the lender to the auditing firm has beneficial ownership in the audit client's equity securities and that investment is material to the lender or to the audit client (and the lender has the ability to exercise significant influence over the audit client).[5]

Another suggested refinement involves provisions related to loan arrangements that change because of secondary market purchases of previously issued debt. To address these circumstances, the CCMC recommends the SEC provide grandfathering provisions similar to those that exist in the current loan rule. Further, we recommend grandfathering all loans with terms that cannot be changed unilaterally by the lender that originated prior to an audit firm's appointment as auditor or prior to the assignment of a covered person to the engagement.

Recommendations for Other Rule Changes

The Proposal requests recommendations for other changes to the SEC auditor independence rules. This request is important given the nature of current market, business, and regulatory considerations. Significant changes in capital formation, business models, business relationships, technology, intellectual capital, and globalization have occurred in the decades since the SEC auditor independence rules were promulgated. These changes reinforce the need for updating the rules. For example, the broad application of decades-old rules fails to appreciate the nature of technological relationships that are essential, not just for quality auditing in today's environment, but to allow for innovations to achieve quality auditing in the future.

Only a finite number of firms have the resources to conduct audits on a global scale. And, not all have relevant expertise in every industry, which could serve to limit the alternatives for issuers in those industries if their primary auditor were to be

[4] See the Proposed Amendments, page 1.
[5] See the Proposed Amendments, page 38.

disqualified. These circumstances, coupled with the fact that many businesses retain one or more of the remaining large audit firms to provide non-attest services that consequently render such firms ineligible to also provide the annual financial statement audit, mean that many public companies would have a single alternative firm if their primary auditor were to become ineligible due to an unintentional independence violation. In some cases, we understand from our members (particularly those with transnational businesses or that operate in niche industries) that the pool of potential auditors would be exhausted entirely, leaving no capable firm as a viable alternative. Of course, even if another audit firm is eligible under the independence rules and otherwise has the requisite industry experience to assume an audit, transitioning between firms can be a costly and time-consuming process for any business.

Further, since the SEC promulgated most of the current rules, a sea-change has occurred in audit regulation with enactment of the Sarbanes-Oxley Act of 2002 that created the Public Company Accounting Oversight Board ("PCAOB") to oversee audits of issuers, as well as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), which added PCAOB inspection authority over auditors of certain broker-dealers.[6] A significant aspect of PCAOB inspections involves audit firm quality control systems; and, a significant element of audit firm quality control policies and procedures encompasses independence, objectivity, and integrity. In addition, over the last several decades, since the SEC promulgated the current auditor independence rules, audit firms have made major investments to significantly improve their quality control systems.

Accordingly, and in conjunction with changes in market and business conditions, regulatory changes and the impact thereof support the need to update the SEC auditor independence rules. Furthermore, audit transformation may change the nature of audits and how audits are performed. The independence rules may need to be updated to reflect these changes. The CCMC strongly encourages the SEC to do so.

Background

Rule 2-01 of Regulation S-X applies to accounting firms and their accountants on audits of all types of entities that file financial statements with the SEC, including

[6] Certain broker-dealers that register and file audited financial statements with the SEC are not issuers as defined by SOX. Until enactment of Dodd-Frank, audits of these entities by public accounting firms, even though registered with the PCAOB, were not subject to PCAOB inspections.

operating companies, registered investment companies, registered investment advisers, pooled investment vehicles, and registered broker-dealers. Rule 2-01 requires auditors to be independent of their audit clients both "in fact and in appearance." Rule 2-01 provides that "the Commission will not recognize an accountant as independent with respect to an audit client if the accountant is not (or if a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not) capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."[7]

Rule 2-01 contains four guiding principles for assessing an auditor's independence. In addition, Rule-2-01 has an extensive, albeit nonexclusive, list of detailed circumstances that the Commission considers inconsistent with the auditor independence standard.

The CCMC strongly supports the SEC updating the nonexclusive list of detailed circumstances and related specifics in light of the many changes previously discussed. Among the CCMC's recommendations for updates in the current auditor independence rules are the following: provide transition provisions for initial public offerings ("IPOs), revise the provisions related to affiliates and the investment company complex ("ICC"), reconsider the scope of the rules related to business relationships, and expand the safe harbor for inadvertent and *de minimis* violations.

Provide Transition Provisions for IPOs

The CCMC shares a common concern with many others that a decline in public companies has created fewer opportunities for American families and businesses.[8] Going public by offering shares to the general public through an IPO has long been the goal of entrepreneurs to raise the capital needed to create jobs and expand opportunities for their employees and customers. IPOs also allow "Main Street" investors to own a direct economic stake in the success of American enterprises.[9] Thus, it is important to identify and address any impediments to going public because of the SEC's auditor independence rules.

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[7] See the Proposed Amendments, pages 5-6.
[8] For example, see *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public* (Spring 2018) by the CCMC, American Securities Association, Bio, the Equity Dealers of America, SIFMA, Technet, Nasdaq, and the National Venture Capital Association.
[9] See *Expanding the On-Ramp*, page 4.

One such potential impediment is that companies seeking to go public through an IPO are required to ensure that their auditor has been independent in accordance with the SEC's rules during the two to three-year (look-back) period preceding the IPO. Any instance of a failure to comply with the SEC's auditor independence rules during this look-back period is not curable. As a result of these rules, it requires several years of advance planning when considering a public offering to ensure there are no auditor independence violations.

The SEC's independence rules apply for an IPO even though the auditor has been in compliance with the independence standards of others, such as those of the American Institute of Certified Public Accountants ("AICPA"), and state laws during the look-back period.

Further complicating necessary compliance is that the SEC's auditor independence rules, promulgated nearly two decades ago, do not contemplate the nature and sources of investments, or the relationships in conjunction with such investments that occur in the current environment prior to considering an IPO.

Providing a grace period or allowing companies considering an IPO to use an auditor that is independent under other applicable standards, such as those of the AICPA, would help address this issue, which is consistent with the Congressional intent of the Jumpstart Our Business Startups Act (JOBS).

Revise Affiliate and ICC Provisions

The SEC's auditor independence rules also specify a broad set of entities with which an auditor is precluded from having certain relationships with and to which an auditor is precluded from providing certain services to. Under the so-called "up and over" provisions of the SEC's rules, an auditor needs to be independent with respect to the audit client and any affiliate of the audit client. Affiliates of an audit client include entities that control the audit client, entities over which the audit client has control, and entities under common control with the audit client; entities over which the audit client has significant influence (unless the entity is not material to the audit client) and entities that have significant influence over the audit client (unless the audit client is not material to the entity); and each entity in an ICC.

The scope of the provisions would capture many entities even though their only relationship to each other is that they are commonly controlled by an affiliate. To illustrate, inclusion in a private equity fund portfolio of companies will often be

considered indicative of common control. Thus, an auditor of one portfolio company that is not material to the private equity fund, needs to be concerned about and monitor its interactions with all portfolio companies in the complex. This is the case even if that auditor does not audit the private equity fund or any "brother or sister" entities. Furthermore, if an auditor has an impairment with one fund in a larger ICC, that minor impairment can prevent the auditor from being independent with regard to not just the other attenuated entities in the ICC but also the ICC's investment adviser and the investment adviser's public company parent.

These are just a few examples of circumstances that do not impact an auditor's ability to exercise objective and impartial judgments on all issues encompassed within the audit engagement. The CCMC recommends that the SEC recraft the definitions of audit client and affiliates, along with the circumstances relative to these definitions, to focus on what truly matters from the standpoint of auditor independence.

Reconsider Business Relationship Rules

We recommend the SEC reconsider the scope of the rules related to business relationships. The rules present practical challenges in regards to the business relationship provisions.

Further, we recommend that the SEC replace "the substantial stockholder in a decision-making capacity" concept that currently exists related to business relationships with the significant influence test as reflected in the Proposed Amendments to the loan rule. The concept is similar to that of a beneficial owner with significant influence over the audit client. The same standard should be used for business relationships to identify substantial stockholders in a decision-making capacity.

Expand the Safe Harbor

The SEC's auditor independence rules contain a safe harbor provision for inadvertent and *de minimis* violations under certain very limited circumstances. However, the current provision applies to limited aspects of the auditor independence rules and only to individual accountants and not to audit firms.

The CCMC recommends that the SEC expand the safe harbor provision, to include business relationships and non-audit services, when the violation is inadvertent and corrected promptly and the audit firm maintains an adequate quality

control system. A safe harbor would recognize circumstances can occur that do not concern a reasonable investor from the standpoint of auditor independence, in either fact or appearance. Such circumstances do not impact an auditor's ability to exercise objective and impartial judgments on all issues encompassed within an audit engagement. An expanded safe harbor also considers the current audit regulatory environment, including PCAOB oversight through inspections.

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Thank you for your consideration of the CCMC's recommendations and we stand ready to discuss them with you further

Sincerely,

Tom Quaadman