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SEC Updates Rules on Auditor Independence

In an effort to modernize its auditor independence rules, the SEC recently adopted amendments to certain auditor independence requirements set forth in Regulation S-X (available here). Under the amendments, certain relationships and services that previously would have run afoul of the independence requirements, and that the SEC believes do not impair the objectivity or impartiality of auditors, will be permitted. By reducing some of the compliance-related challenges and burdens associated with the scrutiny of these relationships and services, the SEC expects that auditors, their clients and audit committees will be able to more meaningfully focus their attention on those relationships and services that may in fact pose threats to auditor independence. In addition, by increasing the scope of permitted services and relationships, these amendments should, as noted by SEC Chairman Clayton, "improve competition and audit quality by increasing the number of qualified audit firms from which an issuer can choose."

In their joint dissenting statement, SEC Commissioners Crenshaw and Lee expressed concern that these amendments continue a general trend toward relaxing auditor independence requirements, and that the amendments allow auditors too much discretion, without adequate guidance or supervision, to assess the "materiality" and "significance" of certain relationships, and as a result, their own independence.

New Term: "Entity under Audit"

For greater clarity and to reduce the risk of interpretative circularity, and to better focus certain required analyses and inquiries, the SEC has introduced a new term, "entity under audit" in Rule 2-01, to distinguish between the specific entity under audit, and the broader "audit client" (which latter term includes affiliates of the entity under audit).

Amendments to the Affiliate Definitions

Entities under Common Control

Currently, entities under common control (sister entities) are considered affiliates for the purpose of evaluating auditor independence. The SEC has amended Rule 2-01(f)(4) to include a dual materiality standard for assessing whether entities under common control are affiliates for the purpose of assessing auditor independence. Under this new dual materiality threshold, only if both (a) the entity under audit is material to the controlling entity and (b) the sister entity is material to the controlling entity, will the sister entity be considered an affiliate of the entity under audit.

The SEC initially proposed introducing a single materiality standard to the affiliate definition for entities under common control (which would require a determination of whether the sister entity was material to the controlling entity), but in response to comments, adopted the dual materiality threshold. As a result, the common control/affiliate analysis will conclude if a determination is made that an entity under audit itself is not material to the controlling entity, alleviating the burden of conducting a materiality analysis for each sister entity.

Investment Company Complex

The amendments make similar changes in the case where the entity under audit is an investment company or an investment advisor or sponsor. In those circumstances, the auditor and audit client must look to the definition of "investment company complex" or "ICC" set forth in Rule 2-01(f)(14), as amended, to identify affiliates.

Materiality

While the release provides certain examples to illustrate the application of these amended rules, the SEC expressly declined to provide any specific guidance on materiality. Instead, the SEC stated it expects auditors and their audit clients to continue to use approaches already developed to determine materiality under current rules, and reiterated that any materiality analysis would require consideration of both qualitative and quantitative factors.

Harmonized Look-Back Period for First-Time Filers

The amendments harmonize the "audit and professional engagement period" for purposes of assessing auditor independence for domestic issuers and foreign private issuers that are first-time filers. Domestic issuer first-time filers will now be subject to the same, shorter look-back period as foreign private issuer first-time filers – starting 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 SEC (instead of the current much longer period covering the financial statements as well as the period of the engagement of the auditor to audit or review the financial statements).

The SEC confirmed that this shorter look-back period will be applicable also to reverse mergers that are in substance similar to an IPO.

Business Relationship Rule

Under the current business relationship rule (Rule 2-01(c)(3)), the accounting firm or any covered person may not, at any point during the audit and professional engagement period, have "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" other than the provision of professional services (*i.e.*, the audit engagement and any permitted non-audit services) or as a consumer in the ordinary course of business.

The amendments focus the analysis on those associated persons with decision-making capacity over the entity under audit:

- "audit client's officers, directors" is to be replaced with "audit client's officers or directors that have the ability to affect decision-making at the entity under audit"; and
- "substantial stockholders" is to be replaced with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence of the entity under audit."

The latter change, replacing the previously undefined term "substantial stockholder" with "beneficial owners with significant influence," reflects the updates the SEC made to the loan provision in 2019 and the concept of "significant influence," which is also used elsewhere in Regulation S-X.

Corresponding Loan Provision Changes

For consistency, the SEC made conforming changes to the loan provision (Rule 2-01(c)(ii)(A)) to reflect the changes made to the business relationship rule – *i.e.*, focusing on officers and directors with decision-making authority, and focusing on decision-making authority/significant influence over the entity under audit (as opposed to the audit client).

Particular Relationships

Student Loans

The amendments add student loans to the list of permissible loans an accountant may have without compromising independence. To qualify, the student loans must be obtained from a financial institution under its normal lending procedures, terms and requirements, and must be obtained prior to the individual becoming a covered person in the firm. The SEC clarified that this exception will also include student loans obtained by immediate family members of the covered person, and will not be subject to dollar limits.

Mortgage Loans

The amendments clarify that multiple mortgage loans (instead of just one) are permissible without compromising independence, so long as they were obtained from a financial institution under its normal lending procedures, terms and requirements, are collateralized by the borrower's primary residence and

were obtained prior to the individual becoming a covered person in the firm. The SEC declined to extend this exemption to loans collateralized by a non-primary residence.

Credit Cards/Consumer Loans

The amendments expand the prior exception for credit card balances owed to audit clients to include consumer loans, provided that, as was the case prior for credit card balances, any aggregate outstanding consumer loan balance must be reduced to $10,000 or less on a current basis taking into consideration the payment due date and any applicable period.

Transition for Inadvertent M&A Violations

The amendments adopt a framework (in revised Rule 2-01(e)) to allow audit firms and their clients to transition out of services or relationships that, due to a pending merger or acquisition, will no longer meet the independence standards. Specifically, an accounting firm's independence will not be impaired by services and relationships that would otherwise be considered independence violations if:

- the accounting firm is in compliance with applicable independence standards related to such services or relationship (both when the services/relationship originated and throughout the period in which applicable independence standards apply);
- the accounting firm has or will address the services/relationship promptly under relevant circumstances as a result of the occurrence of the merger or acquisition; and
- the accounting firm has in place a quality control system that includes:
  - 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 such services or relationships after initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the transaction.

The SEC noted that where a service/relationship resulting in an independence violation is identified only *after* the effective date of a transaction, the audit firm and the audit client's audit committee will need to consider all relevant facts and circumstances in their evaluation of the auditor's objectivity and impartiality, and may also seek consultation with the SEC's Office of the Chief Accountant.

Prompt Transition

In the adopting release, the SEC was clear that it expects that the problematic service/relationship be addressed before the effective date of the merger or acquisition. Nonetheless, for those situations where

an orderly transition may not be possible without significant disruption, the SEC stated its expectation that the service/relationship be addressed promptly after the effective date of the transaction, and in any event, no later than six months after the effective date of the transaction. The SEC deliberately did not include a reference to the six-month transition period limit in the rule for fear of it becoming standard practice in all situations, even when a shorter period would be reasonable and more appropriate.

Reverse Mergers

The SEC clarified that this transition framework does not apply to merger transactions that are in substance similar to IPOs. As noted above, auditor independence in connection with such transactions should be evaluated using the look-back period, as amended.

Application of General Independence Standard

The SEC affirmed its view that any relationships and services that may now be permissible under amended Rule 2-01(c) or 2-01(e) remain subject to the general independence standard set forth in Rule 2-01(b).[1] In response to comments it received expressing concern about the scope of relationships and services to be so considered, the SEC clarified that the types of relationships and services that must be evaluated under Rule 2-01(b) "are those that are known or should be known to the auditor because of the nature, extent, relative importance or other relevant aspects of the relationships or services."

Effectiveness and Transition

The amendments will take effect 180 days after publication in the *Federal Register*. Auditors may choose to voluntarily comply with the amendments on an early basis at any time after publication of the amendments in the *Federal Register*, provided that if they do so, the final amendments must be applied in their entirety from the date of such early compliance. These rules will apply prospectively only, from the date of adoption or effectiveness, as applicable (with exceptions for the revisions to the exemptions regarding student loans, consumer loans and multiple mortgages).

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[1] The general standard includes, in part, that the "Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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