SEC Adopts Amendments to Auditor Independence Requirements

I. Background

On October 16, 2020, the Securities and Exchange Commission ("SEC") adopted amendments to Rule 2-01 of Regulation S-X to update certain auditor independence requirements.[1] The final amendments are intended to "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." For a discussion of the current rules and the amendments as they were proposed last year, please see our memorandum found here.

The final amendments:

- amend the definitions of "affiliate of the audit client" and "investment company complex" to focus on certain affiliate relationships;
- reduce the look-back period for domestic first time filers;
- add certain student loans and consumer loans to the exclusions from lending relationships impairing independence;
- replace "substantial stockholders" under the business relationship rule with "beneficial owners with significant influence over the entity under audit";
- present a transition framework for mergers and acquisitions; and
- make other updates.

In the following summary of the final amendments, we discuss the principal areas where the final amendments diverge from the proposed amendments.

II. Auditor Independence Amendments Overview

A. Definitions of "Affiliate of the Audit Client" and the "Investment Company Complex"

To further the purpose set forth above, the final amendments address the definitions of "affiliate of the audit client" and "investment company complex." Under the current version of Rule 2-01(f)(4), the definition of "affiliate of the audit client" includes "[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."[2] Rule 2-01(f)(14) similarly uses the phrase "common control" in setting forth the scope of the definition of "investment company complex."[3] Thus, under the current rule, these definitions could result in relationships with and services to "sister" entities (entities under common control with the entity under audit) that are not as likely to threaten an auditor's objectivity and impartiality and creates challenges relating to the ongoing monitoring for independence.

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[1] For the full text of the release, see SEC, Qualifications of Accountants, SEC Release No. 33-10876 (October 16, 2020), available at https://www.sec.gov/rules/final/2020/33-10876.pdf (the "Adopting Release"). Unless otherwise specified, quoted statements in this memorandum are taken from the Adopting Release.

[2] 17 C.F.R. 210.2-01(f)(4) (2020).

[3] *See* 17 C.F.R. 210.2-01(f)(14) (2020).

In the proposing release,[4] the SEC proposed amending the definition of "affiliate of the audit client" to include a materiality requirement for operating companies under common control and to clarify the application of the definition to "operating companies and direct auditors of an investment company or investment adviser or sponsor"[5] to the investment company complex definition. The Proposing Release proposed that a sister entity would be deemed an affiliate of the audit client "unless the entity is not material to the controlling entity."

In the Adopting Release, the SEC adopted a "*dual materiality*" test to determine whether entities are "under common control" for purposes of the definition of "affiliate of the audit client." The proposed amendments had contemplated assessing whether the sister entity not under audit is material to the controlling entity in determining if the sister entity is an "affiliate of the audit client." Under the final amendments' "dual materiality threshold," if either the entity under audit or the sister entity is *not* material to the controlling entity, then the sister entity will not be deemed an "affiliate of the audit client."[6] The final amendments also modify the definition of "affiliate of the audit client" to replace the term "audit client" (which can be read to include affiliates) with "entity under audit" to avoid misinterpretation.

B. Look-Back Period

Under the current Rule 2-01, the term "audit and professional engagement period" is defined differently for domestic issuers and foreign private issuers that are filing a registration statement with the SEC for the first time. Under the current rule, auditors of domestic issuers that are first time filers must be independent under Rule 2-01 during all periods included in the domestic issuer's registration statement, while auditors of a foreign private issuer in the same situation only need to be independent under Rule 2-01 for the most recent fiscal year.

The final amendments are being adopted as proposed, by amending Rule 2-01(f)(5) to apply the one-year look back period to all first-time filers (regardless of whether the issuer is domestic or foreign) for purposes of independence requirements under Rule 2-01.

C. Student Loans and Consumer Loans

Under the current "Loan Provision" (Rule 2-01(c)(1)(ii)(A)), "an accountant is not independent if it has any loan to or from an audit client and certain other persons related to the audit client." The SEC adopted the final amendments to exempt from the Loan Provision certain student loans obtained by an individual prior to becoming a covered person in the firm. The final amendments modified the proposed amendments by removing certain language in order to exclude student loans obtained by a covered person's immediate family members, not just the covered person.[7] The final amendments also clarify that "educational expenses" should not be read as a limitation on the amount of student loans exempt.

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[4] *See* SEC, *Amendments to Rule 2-01, Qualifications of Accountants*, Release No. 33-10738 (Dec. 30, 2019), available at https://www.sec.gov/rules/proposed/2019/33-10738.pdf (the "Proposing Release").

[5] *Id.*

[6] The SEC stated that "where the entity under audit is not material to the controlling entity, an auditor's relationships with or services provided to sister entities would generally not threaten the auditor's objectivity and impartiality."

[7] The proposed amendments proposed to exempt 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" (*see* the Proposing Release, at 80 (emphasis added)), while the final amendments exempt student loans "provided the loans were not obtained while the covered person in the firm was a covered person." The SEC expressly chose not to specify "a numerical limit to the amount of outstanding student loans held by a covered person or a covered person's immediate family members that would be excepted."

Regarding consumer loans, the "Credit Card Rule" (Rule 2-01(c)(1)(ii)(E)) prior to amendment states that "[a]n accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has . . . [a]ny aggregate outstanding credit card balance owed to a lender that is an audit client" for as long as it "is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period."[8] Consistent with the proposed amendments, the final amendments replace the reference to "credit cards" with "consumer loans" and amend the existing exceptions to instead "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." This expands the Credit Card Rule to capture the types of consumer financings routinely obtained, such as retail loans, cell phone plans, and home improvement plans not secured by a primary residence.

D. "Substantial Stockholders" (Business Relationships Rule)

Under the existing "Business Relationships Rule" (Rule 2-01(c)(3)), an accounting firm or covered person in the firm "is not independent if, at any point during the audit and professional engagement period, [it] 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," which includes "an audit client's officers, directors, or *substantial stockholders*."[9] To address the fact that "substantial stockholders" is not defined in Rule 2-01, the final amendments replace "substantial stockholders" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit." Consistent with the changes to the "affiliate"-related definitions noted in II.A. above, the Adopting Release modified the proposed amendments to change "audit client" to "entity under audit" in analyzing whether the decision-maker has significant influence.

E. Transition Framework for Mergers and Acquisitions

The SEC adopted the final amendments in part to address inadvertent violations of the auditor independence rules as a result of mergers and acquisitions. Because it can be difficult to predict whether a merger or acquisition will result in a violation of these rules, the final amendments include a transition framework in which the accounting firm's independence would not be impaired following an audit client's merger or acquisition if the accounting firm:

- is in compliance with the independence standards related to such services or relationships when the services or relationships originated and throughout the period in which the applicable independence standards apply;
- has or will address such services or relationships promptly under relevant circumstances as a result of the occurrence of the merger or acquisition (the Proposing Release had provided that the correction had to occur "*as promptly as possible* under relevant circumstances"); and
- has a quality control system in place (as described in Rule 2-01(d)(3)) that includes the following features:
  - procedures and controls to monitor the audit client's merger and acquisition activity, providing timely notice of any merger or acquisition; and
  - procedures and controls that facilitate prompt identification of such services or relationships after notification of a potential merger or acquisition that might trigger independence violations, but prior to the effective date of the transaction.

[8] 17 C.F.R. 210.2-01(c)(1)(ii)(E) (2020).

[9] 17 C.F.R. 210.2-01(c)(3) (2020) (emphasis added).

III. Conclusion

The amendments will be effective 180 days after publication in the Federal Register. However, voluntary early compliance with the final amendments in their entirety is permitted after the amendments are published in the Federal Register in advance of the effective date.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; or Paul Rafla at 212.701.3388 or prafla@cahill.com; or publications@cahill.com.