SEC Proposes Modernization of Regulation S-X Auditor Independence Rules: First Analysis

A Lexis Practice Advisor® Practice Note by
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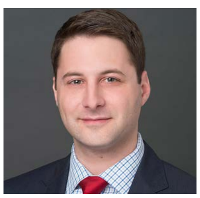

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Introduction

This article discusses proposed amendments to the auditor independence requirements under Rule 2-01 (17 C.F.R. 210.2-01) of Regulation S-X (17 C.F.R. 210.01), which were published for comment in the Federal Register on January 15, 2020 at 85 FR 2332. The proposed amendments focus on the relationships and services that the Securities and Exchange Commission (the SEC) believes are most likely to jeopardize the objectivity and impartiality of the auditor.

For additional information on regulatory and professional accounting and auditing standards, see Accounting and Auditing Professional Bodies and Standards. For an overview of the requirements applicable to financial statements in securities offerings, see Securities Offerings and Financial Statements. For guidance in understanding financial statements, see Financial Statements.

Background

In 2000, the SEC adopted rules regarding auditor independence, including principles for determining whether an auditor is sufficiently independent of its client. The result was Rule 2-01, which sets forth standards of auditor independence and imposes restrictions on auditors "to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance."

As many of the provisions adopted in 2000 have not changed since their inception, the SEC has proposed certain updates to Rule 2-01. The proposed amendments would:

- Amend the definitions of "affiliate of the audit client" and "investment company complex" to focus on particular affiliate relationships
- Reduce the look-back period for domestic first-time filers
- Exclude particular student loans and de minimis consumer loans when determining independence in the context of lending relationships
- Replace "substantial stockholders" under the business relationship rule with "beneficial owners with significant influence" –and–
- Present a transition framework for situations in which auditor independence becomes impaired due to a merger or acquisition

Initial Guidance

The principal changes to Rule 2-01 pursuant to the proposed amendments are summarized below.

- **Definition of "Affiliate of the Audit Client" and "Investment Company Complex."** Rule 2-01(f)(4) defines "affiliate of the audit client" to include "[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." Similarly, Rule 2-01(f)(14) uses the phrase "common control" in defining the scope of the term "investment company complex," defining such term, in relevant part, as "[a]ny entity controlled by or controlling an investment adviser or sponsor . . . or any entity under common control with an investment adviser or sponsor." The proposed amendments add a materiality requirement for operating companies under "common control," which the SEC thinks should reduce the number of entities that are considered affiliates of the client for auditor independence purposes and lighten the compliance burden of determining auditor independence in situations in which related entities under common control are considered immaterial.
- **Reducing the Look-Back Period for Domestic First Time Filers.** Under the current rules, if a domestic company is engaging in an initial public offering (IPO), its auditor needs to be independent during all periods covered by the issuer's registration statement that is filed with the SEC. By contrast, the auditor of a foreign private issuer engaging in the same IPO would have to assess its independence for only the past fiscal year. The proposed amendments seek to fix this discrepancy, amending Rule 2-01(f)(5)(ii) to apply the one-year look-back period to all first-time filers.
- **Student Loans and De Minimis Consumer Loans.** The "Loan Provision" of Rule 2-01 (Rule 2-01(c)(1)(ii)(A)) states, in relevant part, 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 loan . . . to or from an audit client." The proposed amendments would add a student loan exclusion for loans obtained "from a financial institution under its normal lending procedures, terms and requirements," so long as the loan was obtained before such person became a "covered person" under Rule 2-01(f)(11). Rule 2-01(c)(1)(ii)(e) also restricts the independence of auditors who have certain outstanding credit card balances with lenders that are audit clients. The proposed amendments would replace the reference to "credit cards" with "consumer loans" and would carve out certain de minimis loans that are owed to an audit client so long as they are "reduced to $10,000 or less on a current basis taking into consideration the payment due date and available grace period." In proposing these amendments, the SEC reasoned that such limited debt would typically not jeopardize the impartiality of the auditor.
- **"Substantial Stockholders."** The "Business Relationships Rule" of Rule 2-01 (Rule 2-01(c)(3)) limits the independence of certain auditors, accounting firms, and covered persons in the firm if such people 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," including "an audit client's officers, directors or substantial stockholders." Because "substantial stockholders" is not defined in the rule, the proposed amendments would replace such term with "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 SEC believes this will bring clarity and simplicity to the rule.
- **Transition Framework for Mergers and Acquisitions.** The proposed amendments address inadvertent violations of the auditor independence rules as a result of mergers and acquisitions. Under the existing rules, an audit firm could, through no fault of its own, run afoul of the auditor independence rules if its services or relationship with the audit client, which were permissible at the outset, became prohibited under the rules due to a merger, acquisition, or similar corporate event. Recognizing that it can be hard to predict whether a merger or acquisition would result in a violation of the independence rules, the proposed amendments include a transition framework in which the firm's independence would not be impaired following a merger or acquisition. To qualify, an accounting firm must:
  - Comply with the independence standards with respect to the relationships or services when the relationships or services started and throughout the time leading up to the transaction
  - Correct any independence violations that result from such merger or acquisition as promptly as possible under the circumstances –and–
  - Have a quality control system that includes the following:
    - Procedures and controls in place to monitor the merger and acquisition activity of the audit client, providing timely notice of any merger or acquisition –and–
    - Procedures and controls in place that facilitate prompt identification of potential violations after notification of a potential merger or acquisition that might violate the independence standards, but prior to the occurrence of the transaction.

Looking Ahead

Audit firms and their clients will want to monitor the status of these proposed amendments closely, as they will add new considerations that will need to be addressed by existing compliance programs. While the SEC's intention in enacting these amendments is, in part, to reduce burdensome restrictions on audit firms, some energy will undoubtedly need to be expended as audit firms and others adjust to the new rules, once adopted in their final form. Comments to the proposed amendments are due on or before March 16, 2020.

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Geoff's practice is principally focused on securities offerings, leveraged finance and general corporate representation, and his clients include leading investment banks, investment funds, commercial banks, borrowers and issuers. Geoff's corporate finance experience includes public and private high-yield bond offerings, mezzanine debt financings, secured lending transactions, IPOs, PIPES and follow-on equity offerings.

In his general corporate practice, Geoff has extensive experience in the areas of ongoing SEC reporting and disclosure obligations, Sarbanes-Oxley and other compliance programs, NASDAQ listing requirements and delisting procedures, employee equity incentives, corporate governance, strategic planning and related matters. In particular, he has over 20 years of experience practicing in the life sciences industry handling a wide range of transactions, including private and public financings, royalty-based financings, intellectual property licensing, research and development collaborations, commercialization agreements, asset sales and acquisitions.

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Alex represents leading investment banks and commercial banks in connection with public and private capital markets transactions, including debt offerings, high yield bond offerings, equity offerings, bank financings, syndicated institutional loans, asset backed loans, tender offers and exchange offers in connection with acquisition financings, leveraged buyouts, going-private transactions, recapitalizations, bridge lending and loan commitments and other financing transactions.