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SEC Independence Rule Revisions (Part 1):

Affiliate of the Audit Client and *Investment Company Complex*

By: Cathy Allen

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Last December, the Securities and Exchange Commission (SEC) proposed revisions to *Rule 2-01*, *Qualifications of Accountants* with the stated goal of focusing audit firms' independence analyses on relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality. In summary, those changes would:

- amend key terms, *affiliate of the audit client*, *investment company complex*, and *audit and professional engagement period*,
- add certain student and de minimis consumer loans as additional exemptions to the loan rule,
- narrow application of the business relationships rule, and
- introduce a framework for addressing prohibited business and service relationships resulting from corporate mergers and acquisitions.

The comment period closed on March 16, 2020, and on October 16, 2020, the SEC issued a final rule ("Final Release"). The SEC adopted changes largely as proposed but also made a few meaningful and significant, additional changes based on the comments. This article, the first of two, highlights the more significant amendments to two important definitions in the Final Release: *Affiliate of the Audit Client ("Affiliate")* and *Investment Company Complex ("ICC")*.

Affiliate and *ICC* Definitions

An auditor must be independent not only of its audit client but also the audit client's affiliates.

> **(6)** ***Audit client*** means the entity whose financial statements or other information is being audited, reviewed, or attested 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 paragraph (f)(4)(ii) or (f)(4)(iii) of this section.

Affiliate includes entities in an *ICC*, which are entities in the investment company (fund) industry like mutual funds, investment advisers and sponsors, custodial firms, and underwriters. These two definitions determine the universe of entities to which the auditor must maintain independence, therefore, in addition to the audited entity.

Companies Under Common Control

Changes to both definitions focus on identifying the companies that are under common control with the audit client, i.e., "sister companies," as affiliates subject to independence requirements. The current *Affiliate* definition includes all entities under common control with an audit client regardless of whether the company is individually material to the controlling entity:

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

(i) An 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;

(ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

Likewise, the definition of *ICC* includes all sister companies under common control with the audit client.

(14) ***Investment company complex.***

(i) "Investment company complex" includes:

(A) An investment company and its investment adviser or sponsor;

(B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section 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; and

(C) 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. 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) 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.

Proposed Changes

The SEC believes that an auditor's prohibited services or relationships with its client's immaterial sister company typically do not threaten the auditor's objectivity and proposed adding

a materiality qualifier to this aspect of the *Affiliate* definition so that a sister company would only be an *Affiliate* if the sister company was material to the controlling entity.

The SEC also proposed:

- making a similar change to the *ICC* definition subject to certain exceptions discussed below;
- clarifying that the term *investment company* includes unregistered (private) funds and other investment companies excluded by Section 3(c) of the Investment Company Act of 1940;
- that the general standard of auditor independence in Rule 2-01(b) ("general standard") would still apply, meaning that an auditor should consider the nature, extent, relative importance and other aspects of services or relationships between the auditor, the controlling entity, and immaterial (non-affiliate) sister companies;
- clarifying that for an *ICC*, the analysis should start at the affiliate's relationship with the *entity under audit* as opposed to the *audit client (*because *audit client* includes all *Affiliates*, starting the analysis at the *audit client* can add numerous affiliates to the *ICC*);
- clarifying that auditors of an investment company ("*Fund"*), or a(n) investment adviser or sponsor ("*Adviser or Sponsor"*) should look solely to the ICC definition in revised Rule 2-01(f)(14) to identify *Affiliates*.
- clarifying that auditors of a portfolio company should look to revised Rule 2-01(f)(4)(i), which applies to operating companies, *not to* Rule 2-01(f)(14), which applies to entities described in the *ICC* definition; and
- clarifying that the auditor should analyze independence under each of these respective rules relating to the *entity under audit*.

Final Amendments

As noted, the SEC adopted the proposed changes to the rules, with some modifications, which are explained next.

From Materiality Qualifier to Dual Materiality Threshold

The most significant additional change to these definitions (since the December 2019 proposal) was the SEC's agreement to expand the materiality qualifier to a "dual materiality threshold" to identify sister companies as affiliates. The dual materiality threshold means that an auditor should identify an affiliate relationship only if *both* the audit client (specifically, the *entity under audit*, explained further below) *and* the sister company are each material to the entity controlling them. Several commenters successfully argued that services provided to an audit client's sister company do not typically threaten independence when the firm's audit client is immaterial to the controlling entity. This approach is also consistent with how the American Institute of Certified Public Accountants (AICPA) and the International Ethics Standards Board for Accountants (IESBA) Codes identify sister companies as affiliates, which the SEC cited as a benefit.

Replace *Audit Client* with *Entity Under Audit*

The final rules replace *audit client* with the term *entity under audit* in Rule 2-01(f)(4)(i)-(ii) to focus the analysis on the *entity under audit* rather than the *audit client*, which by definition includes all of the audit client's affiliates. The SEC believes the change is necessary to avoid negating the impact of using the dual materiality threshold. The SEC does not intend to make similar changes to other parts of Rule 2-01, including 2-01(f)(4)(iii)-(iv) and changes do not signify a change from the SEC's previous application of these provisions.

Clarifying the Application of the Definitions

As proposed, the Final Release directs auditors of a *Fund*, *Adviser or Sponsor* to look solely to the revised *ICC* definition to identify affiliates. The auditor of a portfolio company in a private equity structure should look to *Affiliate* definition, which applies to operating companies. If a structure includes both portfolio companies and *Funds*, *Adviser or Sponsor*, the auditor should apply the definition depending on the types of entities the firm provides audit services to.

Determining Materiality

The SEC declined to provide specific guidance on materiality in response to commenters' requests but did note that auditors should continue to apply approaches based on current rules. The Final Release added that in some cases, it may be reasonable to use assets under management and that assessments of materiality should be attentive to the:

- nature of the relationship,
- entity's organizational and governance structure,
- certain business and financial relationships, and
- other relevant qualitative factors.

Monitoring Obligations

The SEC stated that auditors and their clients (management and the audit committee) share responsibility for maintaining the auditor's independence. This duty includes monitoring affiliates and obtaining information (including accurate organizational and financial information) to assess materiality of possible affiliates. Once materiality is initially established, auditors should work with the client to ensure they are notified of changes that may impact the client's affiliate relationships (for example, a pending acquisition or registration statement with the SEC) in a timely manner. The auditor should make reasonable inquiries for this information and promptly update its assessment when learning of an SEC filing, transaction, or other relevant information. If changes to the materiality of the *entity under audit* or a sister company to the controlling entity cause an independence violation, the SEC encouraged auditors and their clients to consult with the SEC Office of the Chief Accountant.

Reacting to concerns that information needed to evaluate materiality can be difficult to obtain, the SEC believes its dual materiality threshold should alleviate those concerns since the auditor will not need to assess materiality of the sister company to the controlling entity when the *entity under audit* is ***not*** material to the controlling entity.

Note: The Final Release clarifies that auditors lacking the requisite information to determine whether a sister company is material to the controlling entity should conclude that such sister company is an *Affiliate*.

SEC General Standard (Rule 2-01(b))

The SEC neither proposed nor adopted changes to the general standard (Rule 2-01(b)). However, in discussing these changes, the Final Release stated that auditors should consider relationships and services affected by the proposed revisions to the *Affiliate* definition, both individually and in the aggregate, under the general standard (see below).

> **(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. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

Further, the preliminary note to Rule 2-01 describes four fundamental principles the SEC looks to in evaluating facts and circumstances (see below).

> 2. Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) 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.

Among other things, the nature, extent, or relative importance of the service or relationship may threaten an auditor's independence. For example, a firm may perform numerous services for, or have several business relationships with a non-affiliate sister company; the firm should have sufficient information to evaluate those services and relationship with the non-affiliate to determine whether independence is impacted under the general standard.

Definition of *Investment Company*

As proposed, the Final Release amends the term *investment company* to include unregistered (private) funds and other investment companies excluded by Section 3(c) of the Investment Company Act of 1940.

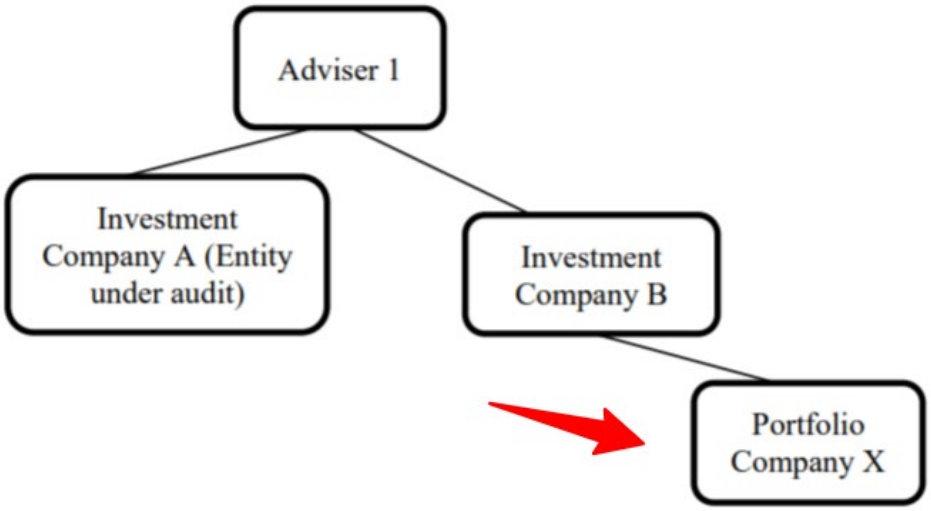
Investment Advisers and Sponsors

The SEC continues to believe that due to the strength of the relationship between a *Fund* and its *Adviser or Sponsor,* a *Fund* that shares the same *Adviser or Sponsor* as the *entity under audit* should be included in the *ICC* regardless of materiality.

Portfolio Companies Controlled by Sister Investment Companies

Responding to several comments, the SEC explained how the amended *ICC* definition applies to a portfolio company controlled by a sister *Fund* (affiliate) of a *Fund* under audit (see below). Under the amended definition, the auditor should apply the dual materiality threshold to any sister companies controlled by the same *Adviser or Sponsor* **unless** the portfolio company provides administrative, custodial, underwriting, or transfer agent services to any entity identified in 2-01(f)(14)(i)(A) or (B), in which case materiality is not considered.

Example 5 – Application of New 17 CFR 210.2-01(f)(14)(i)(C)(*2*)



Note: The amended definition does *not* change the application of the *ICC* definition when a *Fund* under audit controls the portfolio company (in which case materiality should *not* be considered).

Effective Date and Transition

The effective date of these and other amendments to Rule 2-01 will be 180 days after their publication in the Federal Register. Once publication occurs, auditors may apply the rules early if the firm applies the amended rules in their entirety. Auditors should comply with the amended rules on a prospective basis, beginning on the rule's effective date or the date the firm elects early compliance. Auditors may not retroactively apply the final amendments to relationships and services that existed before the effective date (or the early compliance date if selected).