Press Release

SEC Updates Auditor Independence Rules

Amendments Reflect Staff Experience Applying the Auditor Independence Framework

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Washington D.C., Oct. 16, 2020 — The Securities and Exchange Commission today announced that it adopted final amendments to certain auditor independence requirements in Rule 2-01 of Regulation S-X. Informed by decades of staff experience applying the auditor independence framework, the final amendments modernize the rules and more effectively focus the analysis on relationships and services that may pose threats to an auditor's objectivity and impartiality.

The final amendments reflect updates based on recurring fact patterns that the Commission staff has observed over years of consultations in which certain relationships and services triggered technical independence rule violations without necessarily impairing an auditor's objectivity and impartiality. These relationships either triggered non-substantive rule breaches or required potentially time-consuming audit committee review of non-substantive matters, thereby diverting time, attention, and other resources of audit clients, auditors, and audit committees from other investor protection efforts. The final amendments result in auditor independence requirements that will be used to evaluate specific relationships and services, with a focus on protecting investors against threats to the objectivity and impartiality of auditors.

"Today's amendments reflect the Commission's long-recognized view that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence," said Chairman Jay Clayton. "These modernized auditor independence requirements will increase investor protection by focusing audit clients, audit committees, and auditors on areas that may threaten an auditor's objectivity and impartiality. They also will improve competition and audit quality by increasing the number of qualified audit firms from which an issuer can choose."

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FACT SHEET
Amendments to Rule 2-01, Qualification of Accountants
October 16, 2020

Since the initial adoption of the current independence requirements in 2000 and amendments adopted in 2003, the Commission and its staff have continued to learn about the application, efficiency, and effectiveness of auditor independence requirements amidst changing capital market conditions. Additionally, in the May 2018 Proposing Release for Auditor Independence with Respect to Certain Loans or Creditor/Debtor Relationships, the Commission solicited suggestions for other revisions to the independence requirements. In December 2019, the Commission issued the Proposing Release for Amendments to Rule 2-01. The final amendments respond to recent changes in capital market conditions, reflect the Commission staff's experience administering the independence requirements, and incorporate both recent and long-term feedback.

Focusing on Risks to Audit Firm Objectivity and Impartiality
The final amendments seek to focus our auditor independence rules on relationships and services that are more likely to jeopardize the objectivity and impartiality of auditors. The following examples, based, in part, on the SEC staff's consultation experience, help to illustrate some of the concerns with the prior rules that today's amendments address.

Example 1 – Student Loans
Audit Firm has an audit partner based in Atlanta who continues to pay her student loans taken to attend college before starting her career at Audit Firm. A different audit partner in Atlanta audits the lender that provided the student loan, a large student loan company that originates thousands of student loans.

Under the rules prior to today's amendments, the student loan of the audit partner who is not part of the audit would still lead to an independence violation for the audit engagement of the lender. Under the amended rules, that student loan would no longer result in an independence violation for the audit engagement of the lender.

Example 2 – Portfolio Companies
Assume Company X is a U.S.-based portfolio company of Fund F. Fund F invests in various companies around the globe, perhaps dozens or even hundreds, including Company X. Audit Firm A is the auditor of Company X. Also assume that two of Audit Firm A's global network affiliates provide the services discussed below to two separate portfolio companies of Fund F, Company Y and Company Z. Further assume that Company Y and Company Z have no relation to each other or to Company X except for the fact that Fund F is invested in each Company. To add practical context, further assume that:

1. An Australian affiliate of Audit Firm A provides limited staffing services to Company Y — a healthcare portfolio company based in Australia — for a short-period of time to meet a resource need.
2. A Spanish affiliate of Audit Firm A provides payroll services to Company Z – a lodging (hotel chain) portfolio company based in Spain – for a short-period of time.
3. Company X has its own separate governance structure that is unrelated to Company Y or Z, and Company Y and Z are not material to Fund F.

Under the auditor independence rules prior to today's amendments, if Company X registers with the SEC (e.g., by conducting an initial public offering), Audit Firm A would not be independent of Company X as a result of the services provided to either Company Y or Z. This is the case regardless of whether, as the SEC staff has observed in similar situations, these limited services at immaterial portfolio companies (like Companies Y and Z) have no impact on the entity under audit in any way and do not affect the objectivity and impartiality of the auditor in conducting the audit for Company X.

Under the rules prior to today's amendments, Company X would be required: (1) to replace Audit Firm A with another audit firm; (2) to wait to register with the SEC for up to three years after termination of the services provided to Company Y and Company Z; or (3) to make a determination, likely in consultation with Commission staff and/or the audit committee, that the rule violation did not impair the auditor's objectivity and impartiality.

In some situations, the existing audit firm cannot be replaced as a practical matter because all other qualified audit firms have themselves provided services or established other relationships with portfolio companies of Fund F that triggered a breach of our independence rules. The issue of the independence rule set affecting auditor choice is brought home by this example and has increased significantly as the asset management industry has grown, investments have become more global and the global audit services ecosystem has consolidated and become more specialized.

Under the rules as amended, Company X would be able to engage Audit Firm A for audit services. The hypothetical scenario described above is based directly on SEC staff's experience over the past decade. In recent years, the SEC staff conducted a number of consultations in which this fact pattern, or one similar to it, was raised to the SEC staff by the registrant's audit committee and its auditor, and the SEC staff, under such circumstances, did not object to the auditor's and the audit committee's conclusion that the auditor's objectivity and impartiality would not be impaired. SEC staff has provided similar feedback in these types of scenarios over the past decade. The amended rules would mitigate the need for registrants audit committees and their auditors to seek SEC staff guidance in these scenarios.

Highlights
The final amendments will:

- Amend the definitions of "affiliate of the audit client," in Rule 2-01(f)(4), and "investment company complex," in Rule 2-01(f)(14), to address certain affiliate relationships, including entities under common control;
- Amend the definition of "audit and professional engagement period," specifically Rule 2-01(f)(5)(iii), to shorten the look-back period, for domestic first time filers in assessing compliance with the independence requirements;
- Amend Rule 2-01(c)(1)(ii)(A)(1) and (E) to add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships;

- Amend Rule 2-01(c)(3) to replace the reference to "substantial stockholders" in the business relationships rule with the concept of beneficial owners with significant influence;
- Replace the outdated transition provision in Rule 2-01(e) with a new Rule 2-01(e) to introduce a transition framework to address inadvertent independence violations that only arise as a result of a merger or acquisition transactions; and
- Make certain other miscellaneous updates.

What's Next?

The amendments will be effective 180 days after publication in the Federal Register. Voluntary early compliance is permitted after the amendments are published in the Federal Register in advance of the effective date provided that the final amendments are applied in their entirety from the date of early compliance. Auditors are not permitted to retroactively apply the final amendments to relationships and services in existence prior to the effective date or the early compliance date if selected by an audit firm.

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