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SEC amends the Loan Provision of its auditor independence rules

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The SEC's amendments refocus the analysis on debtor-creditor relationships that pose a threat to auditor independence.[1]

Applicability

SEC registered companies, SEC registered investment companies, SEC registered broker-dealers and private funds managed by SEC registered investment advisers.

Key facts and impacts

The SEC's existing Loan Provision specifies that an accountant is not independent when the accounting firm, or any covered person, has a loan to or from:

- an audit client;
- the client's officers and directors; or
- record or beneficial owners of more than 10 percent of the audit client's equity securities.

The SEC's key amendments to the Loan Provision:

- focus the analysis only on beneficial ownership;
- replace the existing 10 percent bright-line shareholder ownership test with a 'significant influence' test;
- add a 'known through reasonable inquiry' standard with respect to identifying beneficial owners of the audit client's equity securities; and
- exclude from the definition of audit client, any other funds that otherwise would be considered affiliates of the audit client for a fund under audit.

The SEC observed that the existing Loan Provision caused many violations related to lending relationships that did not affect the impartiality or objectivity of the auditor.

Why is the SEC amending the Loan Provision?

The SEC said that the existing Loan Provision may not be functioning as intended, and may not effectively identify lending relationships that raise questions about an auditor's objectivity and impartiality. The existing rule has resulted in an unexpected rate of noncompliance, which could cause audit committees and other stakeholders to become desensitized to violations of the independence rules.

[1] SEC Release No. 33-10648; 34-86127, Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships

Additionally, the existing Loan Provision also may have caused companies and auditors to incur significant costs and time to identify and analyze lending relationships that did not threaten the objectivity and impartiality of the auditor in fact or appearance.

The SEC's intention is to "refocus the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client at any time during an audit or professional engagement period." The SEC believes the amendments will "more effectively identify debtor-creditor relationships that could impair an auditor's objectivity and impartiality, and thus will focus the analysis on those borrowing relationships that are important to investors."

Amended Loan Provision

Regulation S-X Rule 2-01 (c)(1)(ii)(A)

The amendments are shown in bold.

(ii) Other financial interests in audit client. An 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) Loans/debtor-creditor relationship.

(1) Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, **or beneficial owners (known through reasonable inquiry) of the audit client's equity securities, where such beneficial owner has significant influence over the audit client…**

***(2)* For purposes of paragraph(c)(1)(ii)(A) of this section:**

(i)* The term *audit client* for a fund under audit excludes any other fund that otherwise would be considered an *affiliate of the audit client;

***(ii)* The term *fund* means: an investment company or an 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)); or a commodity pool…**

Type of ownership

Regulation S-X existing rule	Final amendment
Requires analysis of both record and beneficial ownership.	Focuses the analysis on beneficial ownership rather than on both record and beneficial ownership.

Impact: The Loan Provision will no longer apply to financial intermediaries (e.g. broker-dealers, banks, trusts, insurance companies and other third-party administrators) that hold the audit client's equity securities as a holder of record on behalf of the beneficial owners of the audit client's equity securities.

The SEC believes that amending the Loan Provision to focus on the beneficial ownership of the audit client's equity securities will more effectively identify shareholders "having a special and influential role with the issuer" and therefore better capture those debtor-creditor relationships that may impair the auditor's independence.

Ownership test

Regulation S-X existing rule	Final amendment
Includes a bright-line ownership test of more than 10 percent of the audit client's equity securities.	Replaces the existing 10 percent bright-line shareholder ownership test with a significant influence test similar to other SEC rules and based on the concepts in equity method and joint venture guidance.[2]

[2] The term significant influence is not defined in the amended rules. The SEC believes that "given its use in other parts of the SEC's independence rules and in ASC 323, Investments—Equity Method and Joint Ventures, the concept of significant influence is one with which audit firms and their clients are already required to be familiar and would effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality."

Ownership test	
Impact: The amended Loan Provision is more aligned with circumstances representing threats to the audit firm's independence. The SEC believes that in situations where the lender is unable to influence the audit client through its holdings, the lender's ownership of an audit client's equity securities alone would not threaten an audit firm's objectivity and impartiality. The SEC also commented that it continues to believe that the significant influence test would more effectively determine which shareholders have a special and influential role by focusing on a shareholder's ability to influence the policies and management of an audit client.	
Identifying beneficial ownership	
Regulation S-X existing rule	**Final amendment**
Requires identification of underlying beneficial owners, which may be difficult and complex to access or possibly unavailable to audit clients.	Adds a known through reasonable inquiry standard with respect to the identification of beneficial owners of the audit client's equity securities.
Impact: An audit firm, in coordination with its audit client, would only be required to analyze whether beneficial owners of the audit client's equity securities that are known through reasonable inquiry have significant influence over the audit client. The SEC believes auditors and their audit clients could conduct the reasonable inquiry by evaluating the audit client's governance structure and governing documents, and reviewing SEC filings about beneficial owners or other information prepared by the audit client that may relate to the identification of a beneficial owner. The SEC commented that "if an auditor does not know after reasonable inquiry that one of its lenders is also a beneficial owner of the audit client's equity securities, including because that lender invests in the audit client indirectly through one or more financial intermediaries, the auditor's objectivity and impartiality is unlikely to be impacted by its debtor-creditor relationship with the lender."	
Definition of audit client	
Regulation S-X existing rule	**Final amendment**
The current definition of audit client in Rule 2-01 of Regulation S-X includes all "affiliates of the audit client," including other entities in the audit client's Investment Company Complex (ICC).	For purposes of the Loan Provision, the amended rule excludes from the definition of audit client, for a fund under audit, any other fund (e.g. a 'sister fund') that otherwise would be considered an affiliate of the audit client.
Impact: The Loan Provision will no longer implicate the loans of the audit firm or covered persons in the firm with owners of the equity securities of funds when those funds are affiliates of a fund audit client. The SEC noted, "In the investment management context, investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex." Further, the SEC expanded the definition of 'fund' in the final amendments to include a commodity pool as defined in Section 1a(10) of the US Commodity Exchange Act, as amended [(7 U.S.C. 1-1a(10)], that is not an investment company or an 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)). The SEC also noted that "a foreign fund that is part of an ICC would be covered by the exclusion for funds other than the fund under audit."	

Other comments

When the SEC proposed the amendments in May 2018, it also solicited comments about what other changes should be made to the Loan Provision and other audit independence rules in Rule 2-01 of Regulation S-X.

In the Final Release, the SEC commented that "in response to these comments and the need for more information gathering as to how best to address these categories of comments, the Chairman has directed the staff to formulate recommendations to the Commission for possible additional changes to the auditor independence rules in a future rulemaking."

Effective dates and transition

The final rules are effective 90 days after the date of publication in the Federal Register. The SEC did not provide transition guidance.

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