# SEC Eases Auditor Independence Requirements

**October 23, 2020**

On October 16, 2020, the SEC adopted final amendments to its auditor independence framework under Regulation S-X, largely as proposed in December 2019.[1] The final amendments are intended to, among other things, reduce the impact that SEC independence rules have on auditor choice and provide new flexibility for the private equity/asset management industry and their portfolio companies.

Arguably the most significant change relates to the treatment of "sister" companies, *i.e.*, companies under common control. The adopting release notes that the SEC has dealt with numerous fact patterns in which a private equity fund portfolio company registering with the SEC wished to engage an auditor but was precluded from doing so by the plain language of the independence framework because the auditor had performed services for a sister company. "This is the case regardless of whether, as the SEC staff has observed in similar situations, these limited services at immaterial portfolio companies … 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." Absent SEC relief, under SEC rules prior to the final amendments, the entity being audited must engage a new independent auditor to perform a new audit of existing financial statements (a time-consuming and costly undertaking, made more difficult in a consolidated market for audit services) or forgo SEC registration. All of these are challenges we have faced in representing clients as they prepare for SEC registration, most notably in the IPO context.

As described below, the final amendments carve out instances where sister companies are sufficiently unrelated as to permit auditors to make an independence determination. The final amendments also address a number of other issues relating to auditor independence, including shortening the look-back period for first-time filers, and establishing a transition framework for inadvertent independence violations as a result of mergers and acquisitions.

[1] The final amendments are found here. See our discussion of the proposed rules here.

**New Materiality Threshold Applies to Both the Entity Under Audit and an Entity Under Common Control.** In an important change from the proposal, the final amendments in most cases apply a "dual materiality" standard, meaning that *both* the "entity under audit" as well a sister company must be material to a common controlling entity before potentially precluding a finding of independence.

Several commenters on the December 2019 proposal requested that the SEC limit the definition of the term "controlling entity" to the private equity firm or ultimate parent entity, which limited definition would not have required that the materiality determination be made at the level of an individual private equity fund. The SEC, however, declined to limit the definition of "controlling entity" in this way, instead cautioning that "all entities that are identified to have control over an entity under audit are controlling entities."

Further, the SEC declined to offer specific guidance on the materiality standard to be applied in connection with the new dual materiality standard. Instead, the adopting release notes that "auditors and their audit clients have developed approaches to determine materiality in compliance with current rules, and [the SEC expects] those approaches would continue to be applicable under the final amendments." The adopting release also notes that it is the shared responsibility of auditors and the entities under audit to monitor for independence, including monitoring affiliates and obtaining information necessary to assess materiality.

Even if an entity under audit and its auditor are able to avail themselves of the new dual materiality standard, the auditor must still satisfy the general independence standard set out in Item 2-01(b) of Regulation S-X, *i.e.*, it must be "capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."

We note that more complex rules may apply when the entity under audit is an investment company, investment adviser or sponsor. We will address such rules in more detail in a future client update.

**Shorter Look-Back Period for IPOs and SPAC Transactions.** The final amendments shorten the "audit and professional engagement period" of first-time domestic filers (including in connection with a reverse merger, such as a special purpose acquisition company or "SPAC" transaction) from the current standard that generally includes multiple fiscal years to a shorter period beginning the first day of the last fiscal year before the issuer files (or was required to file) a registration statement or report with the SEC. Auditors must examine relationships during the audit and engagement period to determine independence. As a result, shortening the period should reduce the expense

and difficulty of determining auditor independence.[2] The new, shortened period aligns with the period that was previously applied only to first-time foreign private issuer filers.

**Transition Framework for Inadvertent Violations Due to Mergers and Acquisitions**. The final amendments also establish a transition framework to address inadvertent independence violations as a result of mergers and acquisitions. An accounting firm will not be considered in violation solely because it fails to be independent after a merger or acquisition by its client (or its affiliates), provided it satisfies the following criteria:

- the accounting firm is in compliance with the applicable 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;
- the accounting firm has or will address such services or relationships promptly under relevant circumstances as a result of the occurrence of the merger or acquisition; and
- the accounting firm has in place a quality control system that has procedures and controls that:
  - monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition; and
  - allow for prompt identification of such services or relationships after initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the transaction.

**Other Significant Topics**. Other significant topics addressed by the final amendments include:

- Exclusion from the determination of auditor independence of certain student loans entered into prior to employment in a firm, mortgage loans on a primary residence, and *de minimis* consumer loans.
- With respect to the list of persons related to the auditor for the purposes of restricting business relationships between the entity under audit and persons related to the auditor, replacing the term "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 audit client." This change is expected to simplify compliance with the business relationships rule by using the

[2] The adopting release notes that relationships and activities before the shortened period may still be relevant under the general independence standard of Item 2-01(b) of Regulation S-X.

term "significant influence" which is already used elsewhere in the auditor independence rules.

**Effectiveness and Early Adoption.** As the SEC noted in its press release summarizing the final amendments, 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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Please do not hesitate to contact us with any questions.

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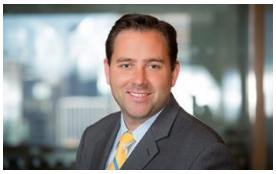

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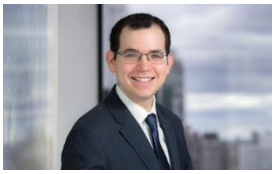

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