

Via Email

June 28, 2018

Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090

*Re: File Number S7-10-18: Auditor Independence with Respect to Certain Loans or Debtor – Creditor Relationships<sup>1</sup>*

Dear Mr. Secretary:

The Council of Institutional Investors (CII), is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding \$3.5 trillion.

Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than \$25 trillion in assets under management.<sup>2</sup>

CII appreciates the opportunity to share our views and provide input on the Securities and Exchange Commission's (Commission or SEC) Proposed Rule, *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships* (Proposed Rule or Proposal).<sup>3</sup> This letter begins with a review of relevant CII policies followed by some observations about the Proposed Rule, and a discussion of, and recommendation on, audit firm governance generally.

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<sup>1</sup> Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Securities Act Release No. 10,491, Exchange Act Release No. 83,157, Investment Company Act Release No. 33,091, Investment Advisor Act Release No. 4,904, 83 Fed. Reg. 20,753 (proposed May 8, 2018), <https://www.gpo.gov/fdsys/pkg/FR-2018-05-08/pdf/2018-09721.pdf>.

<sup>2</sup> For more information about the Council of Institutional Investors ("CII"), including its members, please visit CII's website at <http://www.cii.org/members>.

<sup>3</sup> 83 Fed. Reg. at 20,753.

## CII Policies

CII's membership approved policies reflect the view that external auditors are "financial gatekeepers," and as gatekeepers they:

[P]lay a vital role in ensuring the integrity and stability of the capital markets. They provide investors with timely, critical information they need, but often cannot verify, to make informed investment decisions. With vast access to management . . . information, [auditors] . . . have an inordinate impact on public confidence in the markets. They also exert great influence over the ability of corporations to raise capital . . . .

. . . .

The Sarbanes-Oxley Act of 2002 [SOX] . . . bolstered the transparency, independence, oversight and accountability of accounting firms . . . . For example, accounting firms now are barred from providing many consulting services to companies whose books they audit.<sup>4</sup>

We note that our policies on auditor independence are, at least in some important respects, more demanding than existing U.S. requirements.<sup>5</sup> As one example, our policies provide that "[a] company's external auditor should not perform *any* non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by a company's external auditor."<sup>6</sup>

## Proposed Rule

Consistent with the language and intent of our policies, we share the Commission's view that auditor independence "is essential to reliable financial reporting and critical to the effective functioning in the U.S. capital markets."<sup>7</sup> We also agree with the Commission that "a debtor-creditor relationship between an auditor and its audit client reasonably could be viewed as 'creating a self-interest that competes with the auditor's obligation to serve only investors' interests."<sup>8</sup>

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<sup>4</sup> CII Policies, Policies on Other Issues, Financial Gatekeepers (adopted Apr. 13, 2010), [https://www.cii.org/policies\\_other\\_issues#fin\\_gatekeepers](https://www.cii.org/policies_other_issues#fin_gatekeepers).

<sup>5</sup> See CII, Policies on Corporate Governance § 2.13 Auditor Independence (updated Sept. 15, 2017), [https://www.cii.org/corp\\_gov\\_policies](https://www.cii.org/corp_gov_policies).

<sup>6</sup> *Id.* § 2.13c Non-audit Services (emphasis added); *cf.* U.S. Securities and Exchange Commission, Office of the Chief Accountant, Audit Committees and Auditor Independence (modified May 7, 2007) (listing 6 specific non-audit services), <https://www.sec.gov/info/accountants/audit042707.htm>.

<sup>7</sup> 83 Fed. Reg. at 20,754.

<sup>8</sup> *Id.* at 20,755 (quoting the Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7,919, Exchange Act Release No. 43,602, Investment Company Act Release No. 24,744, Investment Advisor Act Release No. 1,911, 65 Fed. Reg. 76,008, 76,034-35 (final rule Dec. 5, 2000), <https://www.gpo.gov/fdsys/pkg/FR-2000-12-05/pdf/00-30244.pdf>).

We note that the Proposed Rule includes four proposed amendments that would:

- Focus the analysis solely on beneficial ownership;
- Replace the existing 10% 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
- Amend the definition of “audit client” for a fund under audit to exclude from the provision funds that otherwise would be considered “affiliates of the audit client.”<sup>9</sup>

### Alternative Approach

Per our review of the four amendments, we are intrigued by an alternative approach described in the Proposed Rule that would focus on the first of the four amendments.<sup>10</sup> As explained in the Proposal:

An alternative approach to the proposed amendments would be to maintain the 10 percent bright-line test, but to distinguish between types of ownership under the 10 percent bright-line test and tailor the rule accordingly. For example, record owners could be excluded from the 10 percent bright-line test, to which beneficial owners would remain subject.<sup>11</sup>

We agree with the Commission that “[b]eneficial ownership of more than 10 percent of a company’s or fund’s auditor is likely to pose a more significant risk to auditor independence than record ownership of more than 10 percent of the company’s or fund’s securities by the same lender.”<sup>12</sup> We also agree with the Commission that “tailoring the Loan Provision to focus only on the beneficial ownership of the audit client’s equity securities would more effectively identify shareholders ‘having a special and influential role with the issuer’ and therefore better capture those debtor-creditor relationships that may impair an auditor’s independence.”<sup>13</sup>

In our view, the alternative approach appears to have several potential advantages over the Proposed Rule and should be given further consideration. First, the alternative would arguably be simpler and easier to understand than the Proposed Rule. The alternative would appear to be accomplished by simply deleting two words: “or record” from the existing rule.<sup>14</sup>

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<sup>9</sup> *Id.* at 20,759.

<sup>10</sup> *Id.* at 20,769.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 20,766; *see also id.* at 20,767 (“a lender that is a record owner of the audit client’s equity securities may be less likely to attempt to influence the auditor’s report than a lender that is a beneficial owner of the audit client’s equity securities.”).

<sup>13</sup> *Id.* at 20,760 (footnotes omitted).

<sup>14</sup> *See* Regulation S-X, §210-01(c)(1)(ii)(A) (Dec. 5, 2000), *available at* <https://www.law.cornell.edu/cfr/text/17/210.2-01>.

Second, the alternative would arguably address most of the issues that were raised in the June 20, 2016, Commission staff no-action letter that appears to have been the primary impetus for the Proposed Rule.<sup>15</sup> Of the three “circumstances” identified in the letter, it appears that only the third circumstance would *not* be fully addressed by the alternative because the first two circumstances focus solely on record ownership (“An institution that has a lending relationship with an Audit Firm and acts as an authorized participant or market maker to a Fidelity ETF and holds *of record or beneficially* more than 10 percent of the shares of a Fidelity ETF”).<sup>16</sup>

Finally, the alternative avoids replacing the 10% bright line test with a 20% significant influence test.<sup>17</sup> We note that the selection of the existing 10% threshold was based on the Commission’s analysis in 2000 that:

The ten percent threshold corresponds to the definitions in the Commission’s Regulation S–X of a “principal holder of equity securities,” as well as a “promoter.” In addition, other aspects of the securities laws attach significance to an equity interest in excess of ten percent. These definitions and substantive legal provisions clearly classify ten percent shareholders as having a special and influential role with the issuer. Accordingly, a lender owning more than ten percent of an audit client’s securities would be considered to be in a position to influence the policies and management of that client.<sup>18</sup>

Notably all of the 10% thresholds referenced by the Commission in 2000 remain as 10% thresholds today.<sup>19</sup> We, therefore, question what is so unique about auditor independence with respect to certain loans or debtor-creditor relationships that would justify abandoning the existing threshold.

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<sup>15</sup> See 83 Fed. Reg. at 20,759 n.36.

<sup>16</sup> *Id.* (emphasis added).

<sup>17</sup> See *id.* at 20,761 (“Instead, the proposed significant influence test would be consistent with ASC 323 by establishing a rebuttable presumption that a lender beneficially owning 20 percent or more of an audit client’s voting securities is presumed to have the ability to exercise significant influence over the audit client, absent predominant evidence to the contrary.”).

<sup>18</sup> 65 Fed. Reg. at 76,035 (footnotes omitted).

<sup>19</sup> See Regulation S-X, § 210.1-02 (r) (“The term *principal holder of equity securities*, used in respect of a registrant or other person named in a particular statement or report, means a holder of record or a known beneficial owner of more than 10 percent of any class of equity securities of the registrant or other person, respectively, as of the date of the related balance sheet filed.”), available at <https://www.law.cornell.edu/cfr/text/17/210.1-02>; *id.* § 210.1-02 (s)(2) (“Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of securities.”); Securities Exchange Act of 1934, § 240.16a-2 (Nov. 21, 2011) (“Any person who is the beneficial owner, directly or indirectly, of more than ten percent of any class of equity securities . . . registered pursuant to section 12 of the Act . . . director or officer of the issuer of such securities, and any person specified in section 30(h) of the Investment Company Act of 1940 . . . including any person specified in § 240.16a-8, shall be subject to the provisions of section 16 of the Act . . .”), available at <https://www.law.cornell.edu/cfr/text/17/240.16a-2>.

We also note that the proposed 20% significant influence test as proposed would result in the Commission using “the term ‘significant influence’ in the proposed amendment to refer to the principles in the Financial Accounting Standards Board’s . . . ASC Topic 323, Investments—Equity and Joint Ventures.”<sup>20</sup> While we acknowledge that the term “significant influence” has been part of generally accepted accounting principles since 1971, the quality of that standard—setting forth the so-called “equity method”—gives us pause as to whether any term contained therein should be extended to the Proposed Rule.<sup>21</sup> On this point, we tend to agree with the following assessment of the equity method described in a 2007 article by Paul B.W. Miller and Paul R. Bahnson:

[T]he equity method is an anachronistic artifact that no longer makes sense, if it ever did. Despite drastic improvements in the general understanding of capital markets since this method was prescribed . . . , it is still required. Beyond a doubt, financial reporting would be greatly improved if the method was abandoned.<sup>22</sup>

### **Audit Firm Governance**

We would offer a general comment. We believe that improving audit firm governance could potentially enhance the effectiveness of the existing auditor independence rules and auditor independence generally. A good starting point for improving audit firm governance would be to consider requiring the implementation of the governance recommendations contained in the 2008 Final Report of The Department of the Treasury Advisory Committee on the Auditing Profession (ACAP Report).<sup>23</sup>

#### ACAP Report

The Department of the Treasury Advisory Committee on the Auditing Profession (ACAP) was composed of a “philosophically diverse, talented, and committed group of investor, business, academic, and institutional leaders.”<sup>24</sup> The ACAP Report offered 31 recommendations, including the following two recommendations addressing audit firm governance:<sup>25</sup>

- **Recommendation 3. Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting**

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<sup>20</sup> 83 Fed. Reg. at 20,760 (footnotes omitted).

<sup>21</sup> *Id.*

<sup>22</sup> Paul B.W. Miller and Paul R. Bahnson, “It’s Time to Throw the Equity Method Overboard,” *Acct. Today*, Aug. 5, 2007, <https://www.accountingtoday.com/news/its-time-to-throw-the-equity-method-overboard>.

<sup>23</sup> The Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report (Oct. 6, 2008), <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>.

<sup>24</sup> *Id.* at VII:2; III:1-2 (listing the members of the Advisory Committee on the Auditing Profession).

<sup>25</sup> *See id.* at II:3.

**power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms.**<sup>26</sup>

- **Recommendation 7. Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU’s Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of this Report. Further, urge the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.**<sup>27</sup>

### Appointing Independent Members

The basis for the ACAP Report recommendation to enable the appointment of independent members to firm boards references “[s]everal witnesses [that] testified to the benefits of . . . the addition of independent members to the boards of directors[.]” including to decrease potential conflicts of interest.<sup>28</sup>

One witness Paul G. Haaga Jr., then Vice Chairman, Capital Research and Management Company, “called for an entirely independent board with enhanced responsibilities, including . . . monitoring potential conflicts of interest and audit quality.”<sup>29</sup> Another witness cited was Edward E. Nusbaum, then Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International.<sup>30</sup> Mr. Nusbaum testified that “[s]uch a change in the governance model may be one way to strengthen our ability to serve market participants *and reinforce independence.*”<sup>31</sup>

The ACAP found that “enhancing corporate governance of auditing firms through the appointment of independent board members, whose duties run to the auditing firm and its partners/owners, to advisory boards with meaningful governance responsibilities (possible under the current business model), and/or to firm boards could be particularly beneficial to auditing firm management and governance.”<sup>32</sup> The ACAP also found that “such advisory boards and independent board members could improve investor protection through enhanced audit quality and firm transparency.”<sup>33</sup>

### Public Annual Reports

The basis for the ACAP Report recommendation to require larger auditing firms to produce public annual reports references a number of witnesses and commentators including:

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<sup>26</sup> *Id.* at VII:8.

<sup>27</sup> *Id.* at VII:20.

<sup>28</sup> *Id.* at VII:9.

<sup>29</sup> *Id.* VII:9-10.

<sup>30</sup> *Id.* at VII:10 n.37.

<sup>31</sup> *Id.* (emphasis added).

<sup>32</sup> *Id.* at VII:10.

<sup>33</sup> *Id.*

- John Biggs, then Audit Committee Chair, Boeing, Inc., and former Chief Executive Officer and Chairman, TIAA-CREF (“stating that audited financial statements would be useful for audit committees”);
- James D. Cox, Duke University, and Lawrence A. Cunningham, George Washington University (“supporting financial statement disclosure for assessing audit quality and independence”); and
- Mr. Haaga (“calling for auditing firm disclosure of audited financial statements”).<sup>34</sup>

The ACAP found that such public annual reports “could improve audit quality by enhancing the transparency of auditing firms and note[d] that some foreign affiliates of U.S. auditing firms provide such indicators in public reports issued in other jurisdictions.”<sup>35</sup>

Of particular significance, the Co-Chairs of the ACAP, former SEC Chairman Arthur Levitt, Jr. and former SEC Chief Accountant Don Nicolaisen, issued their own joint statement as part of ACAP Report.<sup>36</sup> That statement set a higher standard than the ACAP recommendation:

[A]t least the largest auditing firms should make audited financial statements available, *including to audit committees and the investing public*. Issuance of audited financial statements provides greater transparency and increases discipline and helps sharpen focus, accountability, and trust. The largest auditing firms play a vital role in ensuring the integrity of our capital markets and fairness requires that if a handful of these firms dominate the public company audit market, they should be transparent and provide a level of financial reporting that is generally comparable to that of the public companies they audit. We would encourage the largest firms to do so voluntarily, but if that step does not occur, we would have the PCAOB determine the effective date and precise content of such public reports and disclosures.<sup>37</sup>

### Progress & Update Report

Eight years after the issuance of the ACAP Report the Public Company Accounting Oversight Board’s Investor Advisory Working Group<sup>38</sup> issued a Progress and Update Report on the ACAP recommendations (WG Report).<sup>39</sup> The WG Report “strongly urge[d] the PCAOB and the SEC to implement the ACAP’s recommendations of greater transparency and independent governance in the large international audit firms.”<sup>40</sup>

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<sup>34</sup> *Id.* at VII:22 n.93.

<sup>35</sup> *Id.* at VII:21-22.

<sup>36</sup> *Id.* at II:9.

<sup>37</sup> *Id.* (emphasis added).

<sup>38</sup> Public Company Accounting Oversight Board’s, Investor Advisory Group, Investor Advisory Working Group Progress & Update Report, on Advisory Committee on Accounting Profession’s Recommendations 1 (Oct. 27, 2016) (listing the members of the Investor Advisory Working Group), <https://pcaobus.org/News/Events/Documents/102716-IAG-meeting/ACAP-WG-report.pdf>.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 14.

The basis for the recommendations of the WG Report was critical of the annual public reports of the large U.S. audit firms finding that:

Typically, the U.S. firm report is shorter and noticeably less transparent than the EU annual report. They contain limited financial information with respect to the financial viability of the firm and certainly do not provide a set of financial statements prepared in accordance with generally accepted accounting principles. They also provide limited information to investors with respect to audit quality. In that regard, we believe that the U.S. firm transparency reports are not consistent with “best practice.”<sup>41</sup>

The WG Report also criticized the board structures of the large U.S. audit firms finding that:

Typically, these are governing boards comprised of senior partners, elected by other partners in the firm. As such they are not independent governance structures, and do not provide independent oversight or perspectives consistent with best governance practices today.<sup>42</sup>

#### Speech by Steven B. Harris

Echoing the WG Report criticisms, last December then PCAOB Board Member Steven B. Harris called for regulators to adopt the audit firm governance recommendations contained in the ACAP Report.<sup>43</sup> Mr. Harris explained:

At this year's IAG meeting, members recommended by unanimous consent that the Big Four provide annual audited financial statements. . . . Regulators could use such information to evaluate the risks that different business lines pose to one another or anticipate and mitigate challenges to a firm's ability to conduct high quality audits

....

....

[I]nvestors continue to call for firms to have independent board members on their governance boards. I understand that this is already a requirement in some countries. Requiring independent board members would align the profession with mandated and basic sound corporate governance practice.<sup>44</sup>

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Steven B. Harris, Board Member, PCAOB, Speech at the 2017 International Institute on Audit Regulation (Dec. 7, 2017), <https://pcaobus.org/News/Speech/Pages/Harris-Audit-Industry-Concentration-12-07-17.aspx>.

<sup>44</sup> *Id.*



### Remarks by Wesley Bricker

More recently, SEC Chief Accountant Wesley Bricker discussed audit firm governance in remarks at the 2018 Baruch College Financial Reporting Conference.<sup>45</sup> Without specifically referencing the ACAP recommendations, Mr. Bricker announced that the “leaders of the largest, most complex firms, have appointed, or are taking steps to appoint, independent directors or independent advisory council members with meaningful governance responsibilities.”<sup>46</sup> Mr. Bricker indicated that the purpose of the independent directors should be “to foster audit quality and safeguard against noncompliance threats and the resulting costs to the reputation of the firm, its network, and the audit profession generally.”<sup>47</sup>

Mr. Bricker also discussed how “the largest audit firms voluntarily provide audit quality reports to communicate how the firm performs individual audits, how they run the business, and how they think about the role and relevance of the audit profession.”<sup>48</sup> Mr. Bricker indicated that the those reports should include: “meaningful information about the design of an audit firm’s governance and culture, including the design of the firm’s board, its membership, the particular responsibilities assigned to the members, why a member of a board or advisory council or other structure is determined to be “independent” of the firm, and related information that would inform an audit committee’s consideration of the audit firm’s commitment to factors that impact audit quality.”<sup>49</sup>

### CII Recommendations on Audit Firm Governance

Overlaying Mr. Bricker’s recent comments with the ACAP Recommendations, the related WG Report recommendations, and the call to action by Mr. Harris, CII respectfully recommends the SEC *require* that, beginning in 2019, the larger U.S. auditing firms:

- Appoint independent directors with full voting power to firm boards
- Produce public annual reports incorporating:
  - Audited financial statements of the firm prepared in accordance with U.S. generally accepted accounting principles
  - An audit quality report of the firm including, at a minimum:
    - A discussion of:
      - How they define the U.S. firm and its relationship with foreign affiliates
      - How the firm performs individual audits
      - How they run the business

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<sup>45</sup> Wesley Bricker, Chief Accountant, SEC, Remarks before the 2018 Baruch College Financial Reporting Conference: Working Together to Advance Financial Reporting (May 3, 2018), <https://www.sec.gov/news/speech/speech-bricker-040318>.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

- How they think about the role and relevance of the auditing profession
- How they ensure that all audit professionals understand and appreciate that the investing public is the auditor's primary client
- How they compensate and incentivize audit professionals
- How they have designed the firm's governance and structure
- How have they designed the firm's board, including:
  - Board membership
  - Particular responsibilities assigned to the members
  - Why a member of a board is determined to be "independent" of the firm
    - A discussion of all recommendations offered by the independent members that might impact audit quality and specific actions taken by the firm in response to those recommendations or an explanation why no action was taken
- Information that would inform an audit committee's or investor's consideration of the audit firm's commitment to factors that impact audit quality, including:
  - How the firm defines audit quality
  - How they have designed the firm's processes and procedures to monitor and assure audit quality, including:
    - Disclosure of key indicators of audit quality and effectiveness.

We believe these long overdue improvements to audit firm governance would supplement the SEC's auditor independence rules and improve the efficient functioning of the U.S. capital markets.

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We appreciate the opportunity to comment on the Proposed Rule. Please feel free to contact me with any questions regarding this letter. I can be reached at [jeff@cii.org](mailto:jeff@cii.org) or by telephone at (202) 822-0800.

Sincerely,



Jeffrey P. Mahoney  
General Counsel