

Via Email

December 3, 2020

Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549–1090

**Re: File Number PCAOB-2020-01<sup>1</sup>**

Dear Madam Secretary:

The Council of Institutional Investors (CII) appreciates the opportunity to comment on the Notice of Filing of Proposed Rules on Amendments to PCAOB Interim Independence Standards and PCAOB Rules To Align With Amendments to Rule 2-01 of Regulation S-X (PCAOB Rules).<sup>2</sup>

CII is a nonprofit, nonpartisan association of U.S. 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 of approximately \$4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than 15 million participants – true “Main Street” investors through their pension funds. Our associate members include non-U.S. asset owners with about \$4 trillion in assets, and a range of asset managers with more than \$35 trillion in assets under management.<sup>3</sup>

## **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

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<sup>1</sup> A Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendments to PCAOB Interim Independence Standards and PCAOB Rules To Align With Amendments to Rule 2-01 of Regulation S-X, Exchange Act Release No. 90,473, 85 Fed. Reg. 76,131 (Nov. 27, 2020), <https://www.federalregister.gov/documents/2020/11/27/2020-26145/public-company-accounting-oversight-board-notice-of-filing-of-proposed-rules-on-amendments-to-pcaob>.

<sup>2</sup> *Id.*

<sup>3</sup> For more information about the Council of Institutional Investors (“CII”), including its board and members, please visit CII’s website at <http://www.cii.org>.

markets. They also exert great influence over the ability of corporations to raise capital . . . .

. . . .

The Sarbanes-Oxley Act of 2002 . . . 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>

The importance CII members place on auditor independence is evidenced by the inclusion of an entire section on the topic in our policies.<sup>5</sup> Those policies are in some important respects more demanding than existing Securities and Exchange Commission (SEC or Commission) requirements. Perhaps most relevant to the PCAOB Rules, 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>

We note that in 2016, Public Company Accounting Oversight Board (PCAOB or Board) member Steven B. Harris warned that:

[S]ome members of the profession are calling for ‘modernizing’ or in other words, relaxing the independence rules.

. . . [W]hile things have changed since the passage of the Sarbanes-Oxley Act, it appears that new threats to auditor independence have emerged, and that others have reappeared. The events that preceded the enactment of the Sarbanes-Oxley Act demonstrated the perils investors and our capital markets face when auditor independence is compromised by auditors becoming too cozy with management.<sup>7</sup>

Unfortunately, four years later, some members of the profession that Board member Harris was referring to appear to have succeeded in convincing a majority of the Commission<sup>8</sup> and the

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

<sup>5</sup> CII, Corporate Governance Policies § 2.13 Auditor Independence (updated Sept. 22, 2020) (emphasis added), [https://www.cii.org/files/policies/09\\_22\\_20\\_corp\\_gov\\_policies.pdf](https://www.cii.org/files/policies/09_22_20_corp_gov_policies.pdf).

<sup>6</sup> § 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), <https://www.sec.gov/info/accountants/audit042707.htm> (prohibiting 8 specific non-audit services).

<sup>7</sup> Steven B. Harris, PCAOB Board Member, Introductory Keynote at the International Corporate Governance Network Annual Conference: The Role of the PCAOB in Investor Protection (June 28, 2016), <https://www.icgn.org/introductory-keynote-steven-b-harris-pcaob-board-member>.

<sup>8</sup> *See* Commissioners Allison Herron Lee & Carolina A. Crenshaw, Joint Statement on Auditor Independence Amendments: Who Watches the Watchers? (Oct. 16, 2020), <https://www.sec.gov/news/public-statement/lee-crenshaw-who-watches-watchers> (“We respectfully dissent.”).

PCAOB<sup>9</sup> to relax the independence rules permitting auditors to provide more non-audit services to audit clients<sup>10</sup> to the potential detriment of investors and our capital markets.

Perhaps the most troubling aspect of the PCAOB's Rules is the Board's decision without public comment to align the "definitions of the terms 'affiliate of the audit client' . . . Rule 3501 to be consistent with the SEC's 2020 amendments to the definitions of these terms in Rule 2-01(f)."<sup>11</sup>

### **"Affiliate of the Audit Client" Definition<sup>12</sup>**

As you are aware, the Commission's October 2020 final rule on *Qualifications of Accountants* (Final Rule),<sup>13</sup> narrows the definition of "audit client" to exclude certain affiliated entities within a private equity structure or investment company complex.<sup>14</sup> The Final Rule achieves this result, in part, by adopting a materiality qualifier and the concept of dual materiality.<sup>15</sup>

As indicated in our March 2020 letter in response to the proposed *Amendments to Rule 2-01, Qualifications of Accountants*,<sup>16</sup> we opposed both the materiality qualifier and the concept of dual materiality.<sup>17</sup> As explained in our letter:

CII does not support adding the "materiality requirement, as proposed, so that only sister entities that are material to the controlling entity are deemed to be an affiliate of the audit client." We acknowledge that "[a]uditors . . . have experience in applying a materiality standard when identifying affiliates, whether applying the independence rules of the SEC or [American Institute of Certified Public

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<sup>9</sup> See J. Robert Brown Jr., Board Member, PCAOB Open Board Meeting: Reducing PCAOB Authority Over Auditor Independence (Nov. 19, 2020), <https://pcaobus.org/news-events/speeches/speech-detail/reducing-pcaob-authority-over-auditor-independence> ("I cannot support these amendments.").

<sup>10</sup> See *Qualifications of Accountants*, Securities Act Release No. 10,876, Exchange Act Release No. 90,210, Adviser Act Release No. 5,613, Investment Company Act Release No. 34,052 at 91 (final rule Oct. 16, 2020), <https://www.sec.gov/rules/final/2020/33-10876.pdf> (providing that an example of a benefit of the rule is that "audit firms will not need to discontinue their non-audit services or switch their audit services as a result of certain client affiliations that are no longer deemed independence-impairing under the dual materiality thresholds.").

<sup>11</sup> 85 Fed. Reg. at 76,137.

<sup>12</sup> Id. at 76,137-38.

<sup>13</sup> *Qualifications of Accountants*, Securities Act Release No. 10,876.

<sup>14</sup> Id. at 127-128 (amending the definition of an "affiliate of the audit client").

<sup>15</sup> See, e.g., Syed Farooq, Cohen & Co, SEC Modernizes Auditor Independence Rules (Oct. 28, 2020), <https://www.cohencpa.com/insights/articles/sec-modernizes-auditor-independence-rules> (describing the amendments to the definition "of an affiliate of the audit client: Includes a materiality qualifier with respect to operating companies, including portfolio companies, under common control . . .; [and] Introduces the concept of a 'dual materiality threshold' where a sister entity, which is an entity under common control with an entity under audit, would now be deemed an affiliate of an audit client only if it and the entity under audit were each material to the controlling entity").

<sup>16</sup> Amendments to Rule 2-01, *Qualifications of Accountants*, Securities Act Release No. 10,738, Exchange Act Release No. 87,864, Adviser Act Release No. 5,422, Investment Company Act Release No. 33,737, 85 Fed. Reg. 2,332 (proposed Jan. 15, 2020), <https://www.federalregister.gov/documents/2020/01/15/2019-28476/amendments-to-rule-2-01-qualifications-of-accountants>.

<sup>17</sup> Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Vanessa A. Countryman, Secretary, Securities and Exchange Commission 2 (Mar. 16, 2020), [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2020/March%2016%202020%20SEC%20comment%20letter%20LN1%20\(final\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2020/March%2016%202020%20SEC%20comment%20letter%20LN1%20(final).pdf).

Accountants] AICPA.” However, we note that there is evidence that auditors vary widely in how they assess materiality for financial reporting purposes. *If auditors similarly vary widely in how they assess the materiality requirement as proposed there is a risk the determination of independence may exclude from the consideration sister entities whose relationships with or services from an auditor would impair the auditor’s objectivity and impartiality to the audit client. Given the lack of evidence in the Proposal to evaluate that risk, we are currently unable to support the proposed materiality requirement.*

If, despite our concerns, the SEC adds the materiality requirement as proposed, *we would support the proposed “focus on the materiality of the sister entities to the controlling entity” rather than a double trigger threshold based on the AICPA affiliate definition that focuses “on whether sister entities are material to the entity under audit, in addition to whether they are material to the controlling entity.” We accept the SEC conclusion that the AICPA affiliate definition, if adopted, “may exclude from the proposed definition sister entities whose relationships with or services from an auditor would impair the auditor’s objectivity and impartiality.”*<sup>18</sup>

Consistent with our stated concerns with the materiality qualifier and the concept of dual materiality, we also share the following views of Commissioners Allison Herren Lee and Caroline A. Crenshaw:

Today’s rules [give] . . . auditors greater discretion in assessing their own independence. *The amendments introduce a new materiality analysis into the common control prong of the definition of affiliate and permit auditors to carve out even more entities from the definition of audit client through that materiality analysis. Indeed the final rules go even further than the proposal in reliance on materiality, by introducing a so-called “dual-materiality” analysis into the rule, giving auditors two bites at a materiality analysis to exclude affiliates.* This is concerning in part because we know that auditors may be inconsistent and err in their application of the materiality standard. Thus, whereas the current rule draws a clear line, the final rules introduce more opportunity for uncertainty and error.

We understand that the introduction of the materiality standard into the rules . . . is based in part on the staff’s experience in the consultation process. That is, when auditors have violated independence rules in the past and come to the staff to make the case that their independence is not actually impaired despite a “technical” violation, auditors have relied in part on materiality assessments like those that will now be permitted by these amendments. We appreciate the staff’s professional expertise and experience, and we believe that expertise is invaluable for assisting auditors in analyzing and making these judgments. By writing this broad standard into the rule, however, we place greater reliance on auditors to decide what is or is not “material.” Thus, we rely on auditors to subjectively determine when their own independence is impaired . . . This despite the fact that people and organizations are so often inept at perceiving their own conflicts of interest and/or understanding if

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<sup>18</sup> *Id.* (emphasis added & footnotes omitted).

or how such conflicts may affect their own judgment. *What's more, the rule fails to provide visibility into how auditors apply this standard.*

While it makes sense for us to assess how our rules are functioning from time to time and to recalibrate them as needed, we are concerned that the dial for auditor independence is turning in only one direction, and that is towards loosening standards and reducing transparency. *We cannot support introducing greater opportunity for error and uncertainty into auditor independence standards while decreasing visibility into how auditors are actually making these judgments.*<sup>19</sup>

In light of our shared concerns, we believe that one means of reducing the potential harm to investors and the capital markets that may be caused by PCAOB Rules' incorporation of the SEC's definition of an "Affiliate of the Audit Client" into its standards is for the PCAOB to develop and issue a rule or standard that would address the lack of visibility into how auditors make judgments in applying the definition. For example, we would support a standard or rule that would, at a minimum,<sup>20</sup> "specify the documentation that auditors should prepare and maintain when additional services are provided to an affiliate of an audit client."<sup>21</sup> In our view, such a standard or rule should be written in a manner that achieves the objective of providing the PCAOB, through its inspection process, with sufficient visibility into how auditors assess the new materiality qualifier and the concept of dual materiality. In the absence of the development and issuance of such a documentation rule or standard, we must respectfully oppose the PCAOB Rules.

We appreciate the opportunity to comment on this important matter.

Sincerely,



Jeffrey P. Mahoney  
General Counsel

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<sup>19</sup> Commissioners Allison Herren Lee & Commissioner Caroline A. Crenshaw, Joint Statement on Auditor Independence Amendments: Who Watches the Watchers? (emphasis added & footnotes omitted).

<sup>20</sup> We would also generally support a rule or standard that would modify PCAOB "standards or rules regarding the nature, timing or extent of an auditor's duty to communicate with audit committee in light of these amendments." J. Robert Brown Jr., Board Member, PCAOB Open Board Meeting: Reducing PCAOB Authority Over Auditor Independence (app.). We believe such a rule or standard could also be written in such a manner that it achieves the objective of providing sufficient visibility into how auditors assess the new materiality qualifier and the concept of dual materiality.

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