

Via Email

March 16, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: File Number S7-26–19: Amendments to Rule 2-01, Qualifications of Accountants¹

Dear Madam Secretary:

The Council of Institutional Investors (CII) appreciates the opportunity to comment on the proposed *Amendments to Rule 2-01, Qualifications of Accountants* (Proposal).

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.²

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

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¹ Amendments to Rule 2-01, Qualifications of Accountants, Securities Act Release No. 10,738, Exchange Act Release No. 87,864, Adviser Act No. 5,422, Investment Company Act 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>.

² 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>.

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.³

CII also has membership approved policies explicitly addressing auditor independence.⁴ Those policies are in some important respects more demanding than existing Securities and Exchange Commission (SEC) requirements. 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.”⁵

In furtherance of the language and intent of our membership approved policies, CII offers the following comments in response to select provisions of the Proposal:

II. A. 1. Proposed Amendments to Affiliate of the Audit Client and the Investment Company Complex⁶

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.”⁷ 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 Accountants] AICPA.”⁸ However, we note that there is evidence that auditors vary widely in how they assess materiality for financial reporting purposes.⁹ 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.”¹⁰ 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.”¹¹

³ CII Policies, Policies on Other Issues, Financial Gatekeepers (adopted Apr. 13, 2010), https://www.cii.org/policies_other_issues#fin_gatekeepers.

⁴ See CII, Policies on Corporate Governance § 2.13 Auditor Independence (updated Oct. 24, 2018), https://www.cii.org/corp_gov_policies.

⁵ § 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) (prohibiting 8 specific non-audit services), <https://www.sec.gov/info/accountants/audit042707.htm>.

⁶ 85 Fed. Reg. at 2,333.

⁷ *Id.* at 2,335.

⁸ *Id.*

⁹ See Katherine Schipper et al., Auditors’ Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, 52 J. Acct. Res. 1303 (Dec. 2019), available at <https://onlinelibrary.wiley.com/doi/abs/10.1111/1475-679X.12286> (finding that auditors vary widely in how they assess materiality).

¹⁰ 85 Fed. Reg. at 2,335 (emphasis added).

¹¹ *Id.* at n.20 (emphasis added).

II. A. 2. Proposed Amendment to Audit and Professional Engagement Period¹²

We do not support the proposal “to amend rule 2-01(f)(5) to shorten the look back period for all first-time filers to the most recently completed fiscal year.”¹³ We instead support the alternative to lengthen “the lookback period for [foreign private issuers (FPIs)] . . . to all periods in which the financial statements are being audited or reviewed.”¹⁴

We agree with the SEC that the alternative “would help level the playing field for both domestic and foreign first time filers and reduce the likelihood of potential independence impairing relationships and services.”¹⁵ However, we do not fully share the SEC’s concern that the alternative “may reduce incentives for the first time filers to list in the United States” because the largest percentage of FPI’s with initial public offerings are from China.¹⁶

We note that on February 9, it was reported that in a speech to U.S. Governors, Secretary of State Michael Pompeo was critical of the lack of transparency of Chinese companies.¹⁷ More recently on February 19, SEC Chairman Jay Clayton, SEC Division of Corporation Finance Director Bill Hinman, SEC Chief Accountant Sagar Teotia, and Public Company Accounting Oversight Board (PCAOB) Chairman William D. Duhnke III issued a statement describing continued discussions “with senior representatives of the four largest U.S. audit firms” (Statement).¹⁸ The Statement explained that the discussions included issues relating to U.S. capital market exposure to Chinese companies and the PCAOB’s lack of inspections of the audit work at those companies.¹⁹

Generally consistent with issues identified in the Statement and Secretary Pompeo’s speech, CII has supported actions to address the investor protection and general oversight issues that exist for U.S. Chinese listed companies.²⁰ That view, combined with the dominance of Chinese IPO’s in the FPI market, provides an additional basis for our support of the alternative to lengthen the lookback period for FPI’s.

¹² *Id.* at 2,338.

¹³ *Id.* at 2,339.

¹⁴ *Id.*

¹⁵ *Id.* at 2,350.

¹⁶ IPO Data Compiled by CII Staff (Mar. 3, 2020) (on file with CII) (2019: there were 45 Foreign Private Issuers (FPIs) with 21 (46.7%) of those originated in China; 2018: There were 54 FPIs with 33 (61.1%) of those originated in China.).

¹⁷ Jeff Kearns, Pompeo Says Some U.S. Pension Funds Play Into China’s Hands, Bloomberg (Feb. 9, 2020) (subscription required & on file with CII) (Quoting the Secretary of State: “Their books are not wide open, so it’s difficult to know if the transaction that’s being engaged in is transparent and fair and follows the rule of law”).

¹⁸ SEC Chairman Jay Clayton, SEC Division of Corporation Finance Director Bill Hinman, SEC Chief Accountant Sagar Teotia, PCAOB Chairman William D. Duhnke III, Statement on Continued Dialogue with Audit Firm Representatives on Audit Quality in China and Other Emerging Markets; Coronavirus — Reporting Considerations and Potential Relief (Feb. 19, 2020), <https://www.sec.gov/news/public-statement/statement-audit-quality-china-2020-02-19>.

¹⁹ *See id.* (“Significantly, among those issues is that the Public Company Accounting Oversight Board (PCAOB) continues to be prevented from inspecting the audit work and practices of PCAOB-registered audit firms in China on a comparable basis to other non-U.S. jurisdictions.”); *see also* Colleen Honigsberg, The Case for Individual Audit Partner Accountability, 72 Vand. L. Rev. 1871, 1905 n.137 (2019), available at https://law.stanford.edu/wp-content/uploads/2019/10/Honigsberg_2019.pdf (“Chinese auditors are considered notoriously problematic [and] [t]his is true even for affiliates of respected U.S. accounting firms.”).

¹⁹ 85 Fed. Reg. at 2,339.

²⁰ *See, e.g.*, Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Carolyn B. Maloney, Chair, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Committee on Financial Services et al. 6 (June 18, 2019), https://www.cii.org/files/issues_and_advocacy/correspondence/2019/June%2018%202019%20Letter%20to%20Sub

II. B. 1. Proposed Amendment to Except Student Loans²¹

We generally support the proposal “to except student loans obtained for a covered person’s educational expenses that were not obtained while the covered person in the firm was a covered person.”²² We also generally agree with the SEC that the proposed exception *should not* encompass student loans for a covered person’s immediate family members.²³ On this issue, we share the SEC’s concern “that the amount of student loan borrowings could be significant when considering student loans obtained for multiple immediate family members and thus could impact an auditor’s objectivity and impartiality.”²⁴

II.C. Proposed Amendment to the Business Relationships Rule²⁵

We do not agree with the amendments to replace the term substantial shareholder with the concept of a beneficial owner with significant influence. As we explained in our June 2018 comment letter in response to the SEC’s proposed rule on *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationship*,²⁶ we have several concerns with the concept of a beneficial owner with significant interest including: (1) it attaches a presumptively higher threshold for identifying a special or influential role of a beneficial owner than exists in many other areas of the federal securities laws;²⁷ and (2) the term “significant influence” is derived from an nearly half century old accounting standard that many agree makes little sense and is long overdue from being removed from generally accepted accounting principles.²⁸

II. D. Proposed Amendment for Inadvertent Violations for Mergers and Acquisitions²⁹

We do not support providing “the transition framework to address inadvertent independence violations arising from mergers and acquisitions, as proposed.”³⁰ The SEC describes the proposed transition framework as a means for an auditor and its audit client to “transition out of prohibited services and

[committee%20on%20Investor%20Protection%20Entrepreneurs%20and%20Capital%20Markets%20\(finalF\).pdf](#) (commenting that “there are a number of possible alternative actions the SEC, the PCAOB, the stock exchanges, or Congress could potentially take to address, at least in part, the investor protection and general oversight issues that exist for U.S. Chinese listed companies”).

²¹ 85 Fed. Reg. at 2,339.

²² *Id.*

²³ *Id.* (“the proposed exception would not encompass student loans obtained for a covered person’s immediate family members.”)

²⁴ *Id.*

²⁵ *Id.* at 2340.

²⁶ 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.federalregister.gov/documents/2018/05/08/2018-09721/auditor-independence-with-respect-to-certain-loans-or-debtor-creditor-relationships>.

²⁷ See Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Brent J. Brent, Secretary, Securities and Exchange Commission 4 (June 28, 2018), [https://www.cii.org/files/June%202018%20letter%20to%20SEC%20\(finalJPM\).pdf](https://www.cii.org/files/June%202018%20letter%20to%20SEC%20(finalJPM).pdf) (referencing a Securities and Exchange Commission analysis finding that “other aspects of the securities laws attach significance to an equity interest in excess of ten percent.”).

²⁸ *Id.* at 5 (“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.”).

²⁹ 85 Fed. Reg. at 2,341.

³⁰ *Id.* at 2,342.

relationships”³¹ in a “manner that preserves investor protections.”³² The SEC explains that as proposed the prohibited services and relationship could continue without “corrective action”³³ for up to six months “after the effective date of the merger or acquisition that triggered the independence violation.”³⁴

The SEC indicates that the proposed transition framework could possibly benefit investors because correcting the prohibited services and relationships more promptly “could result in a delay of a merger or acquisition while the auditor and its audit client attempt to resolve the potential independence matters.”³⁵ In contrast to the SEC, we generally do not view a delay in mergers and acquisitions resulting from potential auditor independence matters a “possible detriment” to investors for at least two reasons:³⁶ (1) we agree with the SEC that auditor independence is critical to “investor protection and investor confidence”³⁷; and (2) we believe many, if not most, mergers and acquisitions, ultimately do not enhance long-term shareowner value.

With respect to the second reason, we described in detail the basis for our view in our July 2019 comment letter³⁸ in response to the SEC’s proposed rule on *Amendments to Financial Disclosures About Acquired and Disposed Businesses*.³⁹ That letter reviewed the evidence relating to the benefits of mergers and acquisitions to long-term shareowners and found that:

[R]ecent studies generally indicate negative results from merger activity. For example, one recent study found companies making acquisitions experienced an average share price decline of 4.3% over three years, with 61% of those companies underperforming industry competitors. . . . Overall the recent studies generally demonstrate that acquisitions do not create growth on average, result in underperformance relative to competitors and are correlated with a falling stock price of the acquiring company.⁴⁰

Our conclusion is consistent with a July 2019 Discussion Paper by Luc Renneboog of Tilburg University and Cara Vansteenkiste of University of New South Wales (Discussion Paper).⁴¹ In surveying the academic literature on the failure and success of mergers and acquisitions the Discussion Paper concluded that “[w]hen extending the time window to several years subsequent to the deal, the vast majority of studies report significantly negative returns accruing to acquirer shareholders.”⁴²

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *See id.* (stating that “a delay of a merger or acquisition while the auditor and its audit client attempt to resolve the potential independence matters to the possible detriment of the audit client and investors”).

³⁷ *Id.* at 2,332.

³⁸ *See* Letter from Joseph W. Caputo, Council of Institutional Investors to Vanessa Countryman, Secretary, Securities and Exchange Commission 3-4 (July 29, 2020), https://www.cii.org/files/issues_and_advocacy/correspondence/2019/July%2029%202019%20SEC%20Letter%20Amendments%20to%20Financial%20Disclosures%20About%20Acquired%20and%20Disposed%20Businesses%20Final2.pdf (describing the one-sided nature of the analysis).

³⁹ Amendments to Financial Disclosures about Acquired and Disposed Businesses, Securities Act Release No. 10,635, Exchange Act Release No. 85,765, Investment Company Act Release No. 33,465, 84 Fed. Reg. 24,600 (proposed May 28, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-05-28/pdf/2019-09472.pdf>.

⁴⁰ Letter from Joseph W. Caputo, Council of Institutional Investors to Vanessa Countryman, Secretary, Securities and Exchange Commission at 3 (footnotes omitted).

⁴¹ Luc Renneboog & Cara Vansteenkiste, Failure and Success in Mergers and Acquisitions (July 17, 2019) (CentER Discussion Paper, N. 2019-026, Tilburg: CentER, Center for Economic Research), https://pure.uvt.nl/ws/portalfiles/portal/30669671/2019_026.pdf.

⁴² *Id.* at 7.

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Finally, if, despite our objections, the SEC provides for a transition framework, we believe, generally consistent with CII policy,⁴³ that under *no* circumstances should the auditor be permitted to perform services that involve auditing its own work regardless of the transition framework.⁴⁴

We appreciate the opportunity to comment on the Proposal.

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney".

Jeffrey P. Mahoney
General Counsel

⁴³ See § 2.13c Non-audit Services (“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”).

⁴⁴ 85 Fed. Reg. at 2,342-43 (“32. Should certain prohibited services and relationships continue to be an independence violation regardless of the transition framework such as if the service or relationship results in the auditor auditing its own work?”).