



July 26, 2019

Mr. Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships
(Release No. 33-10491; 34-83157; IA-4904; File No. S7-10-18)**

Dear Chairman Clayton:

In light of the Securities and Exchange Commission's (the "Commission") recent rule adopting release, *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships* (the "Adopting Release"), I am writing on behalf of the American Investment Council (the "AIC") and its members to offer our perspective on potential additional changes to the auditor independence rules in 17 CFR 210.2-01 ("Rule 2-01") that the Commission may wish to consider.

In the Adopting Release, the Commission cited increased competition among audit firms, which could result in a lower cost of capital for investors, as a potential benefit of its rulemaking regarding Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Provision"). The Adopting Release indicated that the Commission's amendments to the Loan Provision, and in particular, certain changes to the definition of "audit client" therein, could "lead to a larger pool of eligible auditors, potentially reducing the costs of switching auditors and creating better matches between auditors and clients."¹ The Adopting Release further explained that:

Improved matching between auditor specialties and audit clients could enable auditors to perform auditing services more efficiently, thus potentially reducing audit fees and increasing audit quality over the long term. Higher audit quality is linked to better financial reporting, which could result in a lower cost of capital. Reduced expenses and higher audit quality may decrease the overall cost of investing as well as the cost of capital with potential positive effects on capital formation.²

The AIC agrees with these statements, and appreciates the Commission's acknowledgment that Rule 2-01 has competitive effects on the market for audit and other services. In our comment letter submitted on July 9, 2018 (the "AIC Proposing Release Comment Letter"), we discussed a number of situations in which Rule 2-01, and in particular the definition of "affiliate of the audit client" in Rule 2-01(f)(4) (the "Affiliate Definition"), limits the number of accounting firms that investment funds and their related entities (including portfolio companies) may choose from in selecting both audit and non-audit services. Under the current Affiliate Definition, many investment firms struggle with the administrative burden of maintaining

¹ Adopting Release, page 59.

² Adopting Release, page 62.

independence under Rule 2-01 with respect to even one “Big Four” accounting firm, and often find switching auditors for any of their funds or related entities (including portfolio companies) to be virtually impossible. Should an investment firm seek to maintain independence with respect to more than one “Big Four” accounting firm, it must go to even greater lengths, which can further restrict its portfolio companies’ choices for obtaining non-audit services. In either case, portfolio companies whose service provider choices are restricted may suffer economic and/or competitive disadvantages that can translate to lower returns, with corresponding negative effects for investors in the relevant investment fund. While the recent changes to the Loan Provision may help to address some of the concerns around choice and competition among accounting firms, the AIC supports the Commission’s consideration of additional amendments to areas of Rule 2-01 beyond the Loan Provision.

In this spirit, the AIC respectfully offers, in Appendix A to this letter, proposed language for modifying the Affiliate Definition, as well as certain related changes to the provision covering business relationships in Rule 2-01(c)(3).³ The modifications we are suggesting aim to preserve an independent accountant’s capability to exercise objective and impartial judgment on all issues encompassed within the accountant’s engagement while addressing certain challenges faced by investment funds, including their management entities and general partners. We believe such changes would also support capital formation by (i) limiting transaction inefficiency and business disruption; (ii) increasing choice and competition among service providers; and (iii) reducing unnecessary burdens and risks to investment funds and needless costs borne by investors. More specifically, these changes would include revising the Affiliate Definition such that:⁴

(A) When an audit client is an entity that is included within a pooled investment vehicle complex, “affiliate of the audit client” would not include portfolio investments of entities within such pooled investment vehicle complex; and

(B) When an audit client is a portfolio investment of an entity that is included within a pooled investment vehicle complex, “affiliate of the audit client” would not include (i) entities within such pooled investment vehicle complex or (ii) other portfolio investments of entities within such pooled investment vehicle complex.

We believe that amending Rule 2-01 in this manner would address a key issue faced by the AIC’s members and investment funds in general, and the AIC respectfully requests that the Commission consider these changes.

We appreciate the efforts of the Commission and its Staff on these matters and look forward to further engagement.

³ The AIC also encourages the Commission to consider addressing other areas of Rule 2-01 of Regulation S-X; a number of relevant issues are identified in the AIC Proposing Release Comment Letter.

⁴ Please refer to Appendix A hereto for definitions of terms used in items (A) and (B).

Respectfully submitted,



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APPENDIX A

Proposed Revisions to 17 CFR 210.2-01

(f)(4) *Affiliate of the audit client* means:

- (i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;
- (ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;
- (iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and
- (iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(v) Notwithstanding the foregoing paragraphs (f)(4)(i) through (f)(4)(iv):

(A) When the audit client is an entity that is included within a pooled investment vehicle complex, "affiliate of the audit client" does not include portfolio investments of entities within such pooled investment vehicle complex; and

(B) When the audit client is a portfolio investment of an entity that is included within a pooled investment vehicle complex, "affiliate of the audit client" does not include (i) entities within such pooled investment vehicle complex or (ii) other portfolio investments of entities within such pooled investment vehicle complex.

New Definitions

(X) *Pooled investment vehicle complex*.

(i) "Pooled investment vehicle complex" includes:¹

- (A) A pooled investment vehicle and its investment adviser or sponsor;
- (B) Any entity controlled by, controlling, or under common control with an investment adviser or sponsor in the foregoing paragraph (f)(X)(i)(A); and
- (C) Any entity over which an investment adviser or sponsor described in the foregoing paragraph (f)(X)(i)(A) has significant influence, or which has significant influence over an investment adviser or sponsor described in the foregoing paragraph (f)(X)(i)(A).
- (D) Notwithstanding the foregoing paragraphs (f)(X)(i)(A) through (f)(X)(i)(C), a pooled investment vehicle complex does not include portfolio investments of entities within such pooled investment vehicle complex.

¹ The purpose of the "pooled investment vehicle complex" definition is to capture, in clauses (A) through (C), essentially all entities within that would otherwise be considered affiliates under (i) through (iii) of the definition of "affiliate of the audit client", so that "portfolio investments" of entities within the pooled investment vehicle complex can be carved out in (D).

(ii) “Pooled investment vehicle” means an investment company or 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)).²

(iii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.³

(iv) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.⁴

(Y) “**Portfolio investment**” of an entity within a pooled investment vehicle complex means:

(i) Any entity (“*direct portfolio investment*”):

(A) That is not a pooled investment vehicle;

(B)⁵ The securities of which, to the extent owned by entities within the pooled investment vehicle complex, and excluding any general partner, managing member, profit interest or similar interest,⁶ are owned primarily⁷ by entities that:

(1) Are organized or advised⁸ by entities within the pooled investment vehicle complex; and

(2) Are organized for the principal purpose of facilitating investment by persons who do not exercise control over:

² The definition of “pooled investment vehicle” is intended to capture a wide range of funds, including typical private funds under Section 3(c)(7) or 3(c)(1) of the Investment Company Act, real estate funds under Section 3(c)(5)(C) of the Investment Company Act, and funds that are registered under the Investment Company Act.

³ Tracks similar concept in the definition of “investment company complex”.

⁴ Tracks similar concept in the definition of “investment company complex”.

⁵ Clause (B) generally is intended to capture portfolio companies that are owned primarily by funds with third-party investors, thereby preventing a pooled investment vehicle complex from attempting to evade the requirements of the rule by establishing “pooled investment vehicles” that are in fact owned by persons or entities that control the adviser.

⁶ In the chain of ownership between a private equity fund and a portfolio company of the fund, there may be intermediate entities used for carried interest or other profit sharing arrangements. The exclusion of “any general partner, managing member, profit interest or similar interest” is intended to remove such interests from the determination of whether the portfolio company is owned “primarily” by entities described in (i)(B). In some cases, such intermediate entities may not technically be “pooled investment vehicles” because they do not rely on a statutory exclusion under Section 3(c) of the Investment Company Act in order to avoid investment company status. (This could be the case, for example, if the portfolio company is a majority owned subsidiary of, and represents 60% or more of the intermediate entity’s assets and therefore does not meet the definition of “investment company” under the statutory test or rely on a Section 3(c) exclusion). In that case, the intermediate entity itself could be a “portfolio investment,” but only if it is not consolidated into the financial statements of any another entity in the pooled investment vehicle complex.

⁷ Owned “primarily” is intended to provide some leeway for investment in a portfolio company by dedicated employee vehicles or similar entities.

⁸ “Organized or advised” is intended to capture both entities that have an investment adviser and intermediate entities (such as blocker entities) that may not have an adviser.

(i) any investment adviser or sponsor within the pooled investment vehicle complex; or

(ii) any entity within the pooled investment vehicle complex that controls such an investment adviser or sponsor; and

(C) That is not consolidated into the financial statements of any other entity within the pooled investment vehicle complex in accordance with U.S. Generally Accepted Accounting Principles; and

(ii)⁹ Any entity:

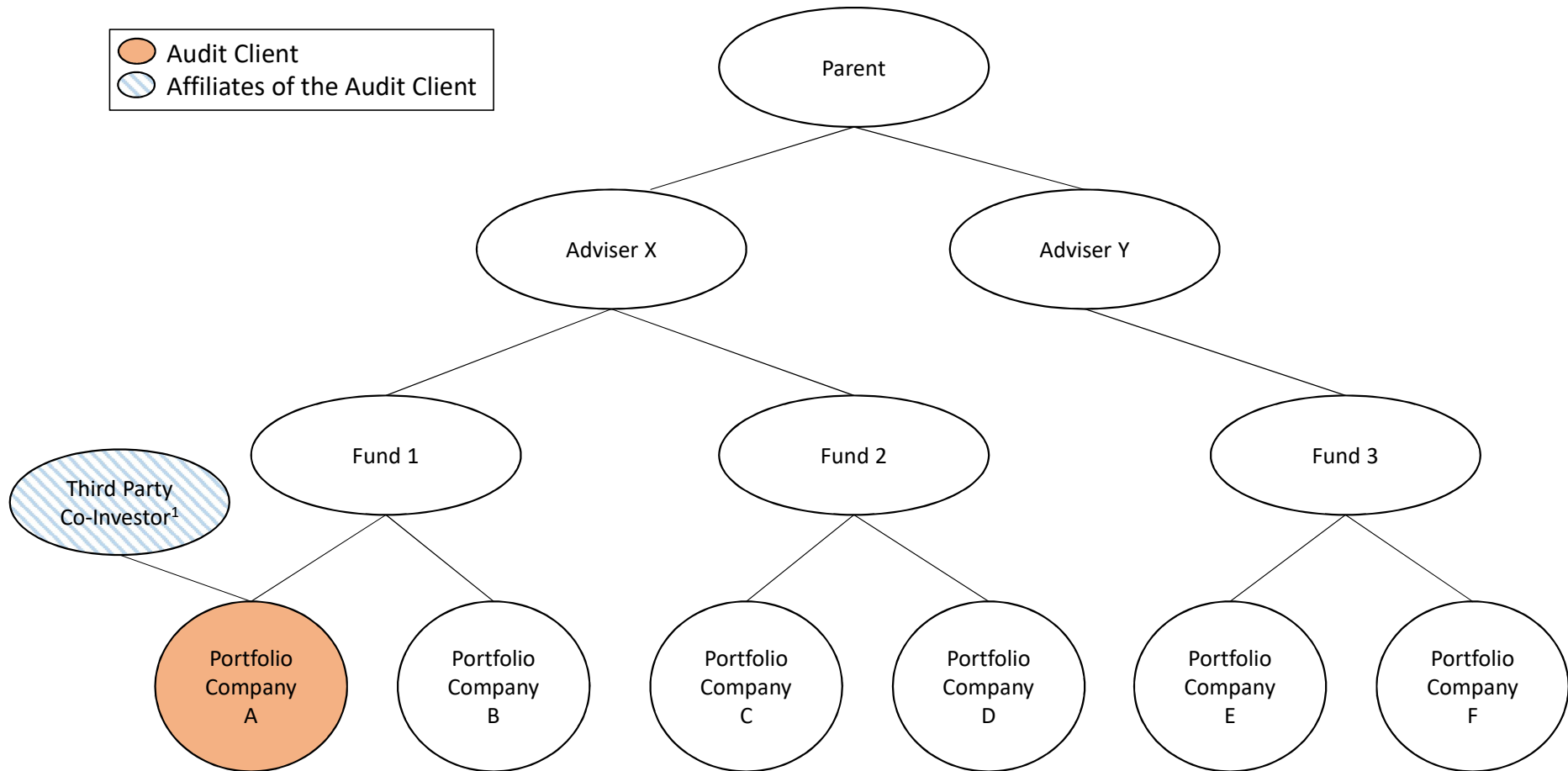
(A) That is controlled by a direct portfolio investment, or over which a direct portfolio investment has significant influence; and

(B) Would not, in the absence of any relationship described in the foregoing paragraph (f)(Y)(ii)(A), be included in the pooled investment vehicle complex.

⁹ Clause (ii) of the definition of “portfolio investment” is included because otherwise an entity that is controlled by a portfolio company, or over which a portfolio company has significant influence, would be considered an “affiliate of the audit client”. For example, suppose Fund X (audit client) owns 100% of PortCo A, and PortCo A owns 51% of Company B. PortCo A would be excluded from “affiliate of the audit client” under clause (i) of the definition of “portfolio investment” (i.e., it is a “direct portfolio investment” of Fund X). Company B, however, would not be a direct portfolio investment because it is not “owned primarily by entities that... [a]re organized or advised by entities within the pooled investment vehicle complex”. It would, however, be controlled by Fund X, and thus be an “affiliate of the audit client [Fund X]”, under clause (i) of the “affiliate of the audit client” definition. Clause (ii) of the definition of “portfolio investment” provides the necessary carveout to address this situation.

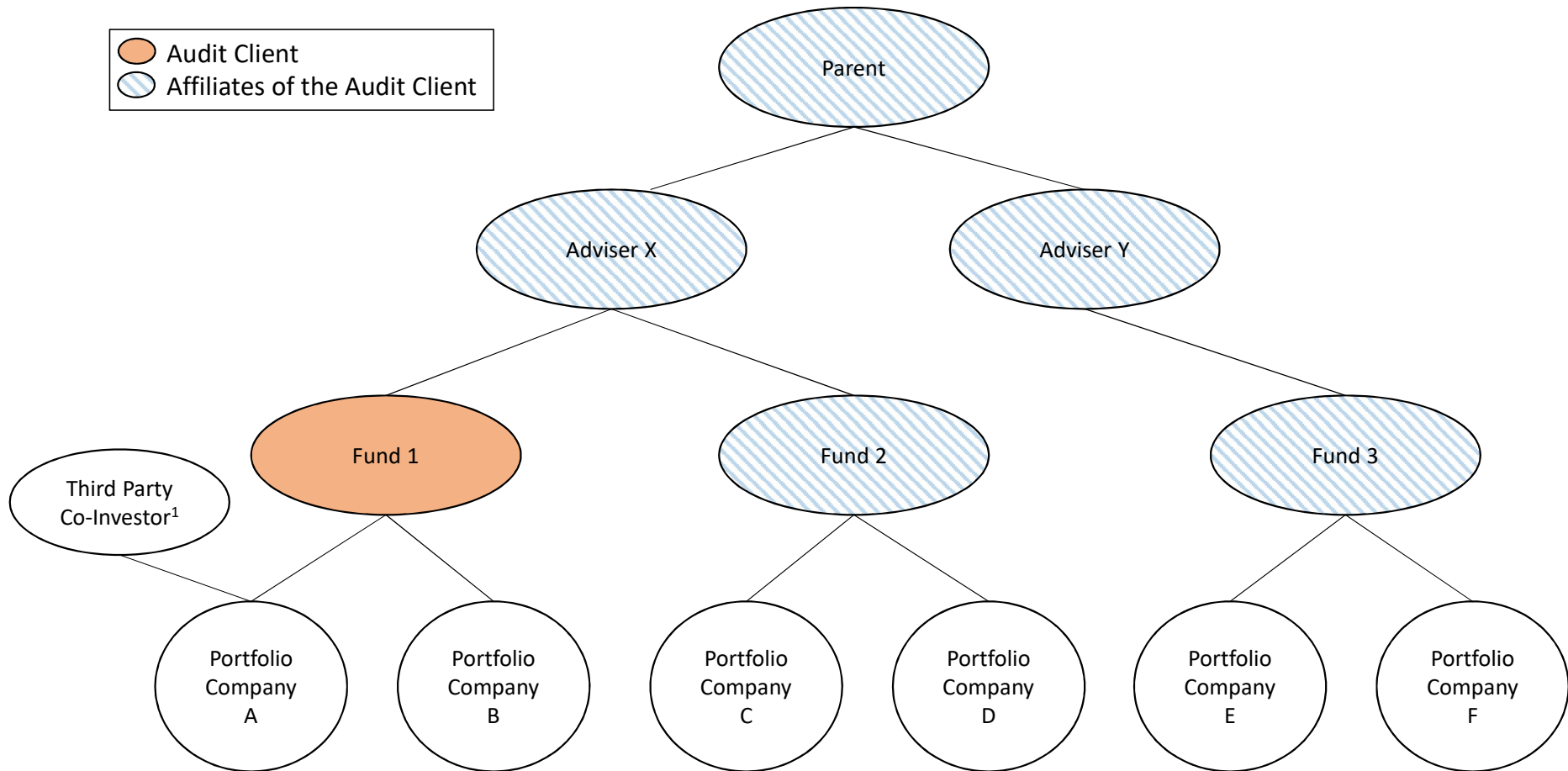
(c)(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the ~~audit client~~ entity whose financial statements or other information is being audited in a decision-making capacity, such as ~~an audit client's~~ the entity's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include (i) a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business or (ii) if the audit client is an entity described in paragraph (f)(4)(v)(A) or (f)(4)(v)(B) of this section, a relationship with an entity, or with persons associated with an entity in a decision-making capacity, excluded from the definition of "affiliate of the audit client" pursuant to such paragraph.

Exhibit A – Portfolio Company as Audit Client



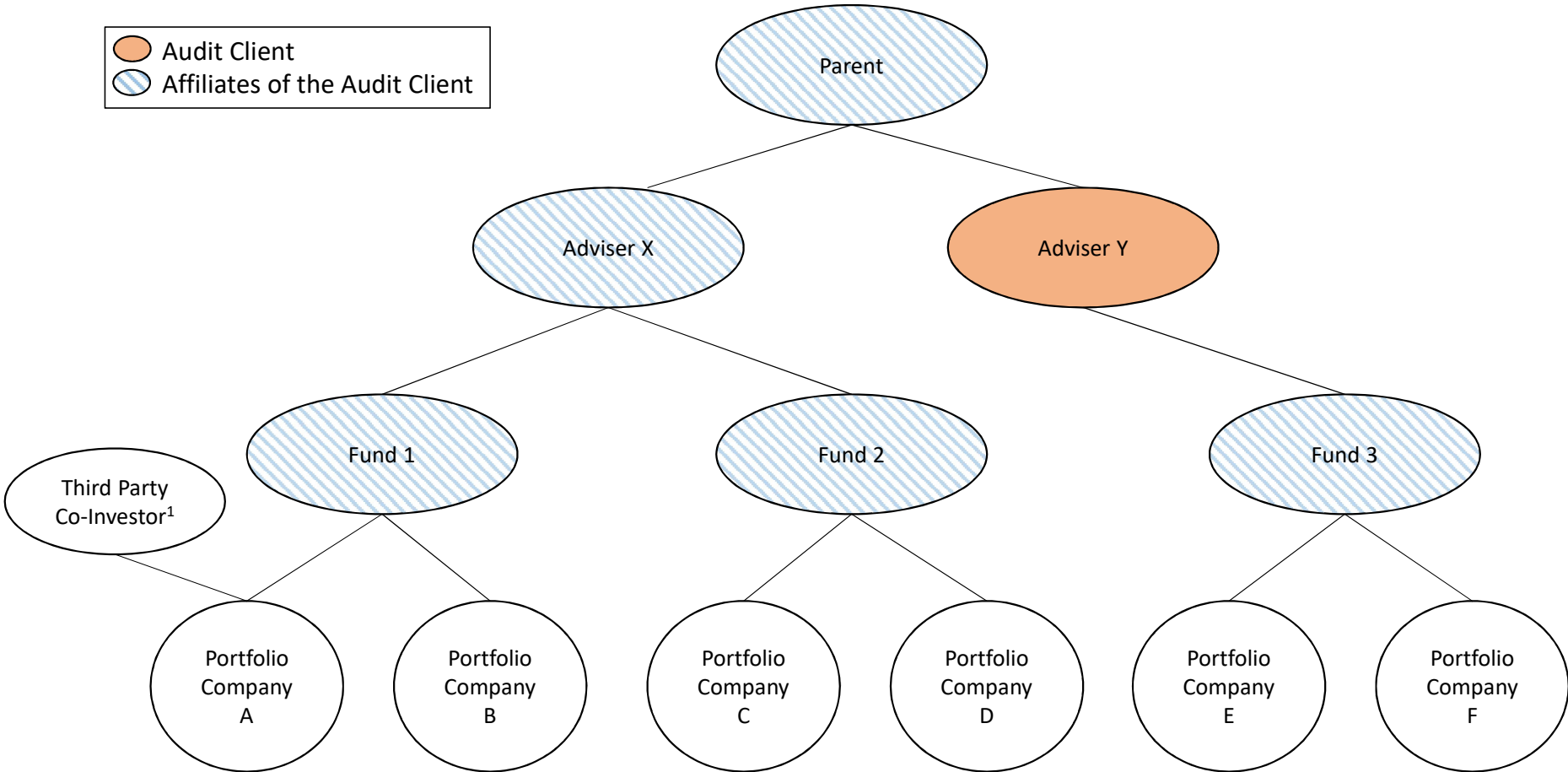
¹ Assumes Third Party Co-Investor is not an entity within a Pooled Investment Vehicle Complex, and meets one of the criteria to be considered an affiliate of Portfolio Company A under 17 CFR 210.2-01(f)(4)(i) through (iii).

Exhibit B – Fund as Audit Client



¹ Assumes Third Party Co-Investor is not an entity within a Pooled Investment Vehicle Complex, and meets one of the criteria to be considered an affiliate of Portfolio Company A under 17 CFR 210.2-01(f)(4)(i) through (iii).

Exhibit C – Affiliated Adviser as Audit Client



¹ Assumes Third Party Co-Investor is not an entity within a Pooled Investment Vehicle Complex, and meets one of the criteria to be considered an affiliate of Portfolio Company A under 17 CFR 210.2-01(f)(4)(i) through (iii).