PRIVATE EQUITY

# Overview of SEC Independence Rules for Private Fund Auditors

Cherry Bekaert LLP
CPAs & Advisors

# Background

The complexity and rate of change for compliance requirements for financial service entities have increased dramatically since the 2008 financial crisis. The U.S. Securities and Exchange Commission ("SEC") has greatly expanded regulatory scope to include many private fund managers and added new reporting, record-keeping and inspection requirements. These changes also have greatly increased the complexity of the regulatory framework for advisors. How funds are structured and how management uses and distributes audited financial statements may affect regulatory compliance. While using various holding companies for acquisitions may be beneficial for tax or legal purposes, the presence of controlling interests in these structures may impose regulatory requirements that did not previously exist.

## Applicable Regulation

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") requires all private fund managers with more than $150 million in assets to file as a Registered Investment Adviser ("RIA") with the SEC under the Investment Advisers Act. RIAs with custody of client assets are subject to the Custody Rule under Section 206(4) of the Investment Advisors Act of 1940 ("Advisers Act") and Advisers Act Rule 206(4)-2.

Advisors to pooled investment vehicles which generally include private investment funds and/or private equity funds can comply with the Custody Rule if, among other things, the pooled investment vehicle is audited at least annually by a PCAOB-registered independent public accountant that is subject to regular inspection by the PCAOB. This does not mean the financial statement audits have to be conducted in accordance with PCAOB audit standards resulting in the issuance of a PCAOB-based audit opinion. However, it does mean auditors of pooled investment funds are subject to the more stringent auditor independence guidelines issued by the PCAOB and the SEC under Rule 2-01 of Regulation S-X ("Rule 2-01"), which require auditors maintain strict independence from SEC audit clients.

Independence for these audit clients also means audit firms are prohibited from performing non-audit services for the funds and many of their portfolio companies. This relationship creates what is known as an Investment Company Complex ("ICC").[1] Entities within the ICC include the advisor, the funds controlled by the advisor and the corresponding portfolio controlled by the fund. Any entity within the ICC is required to be under SEC independence standards from the audit firm performing the fund audit. Rule 2-01(c)(4) of Regulation S-X sets forth a non-exhaustive list of non-audit services which cannot be provided by the audit firm to its audit clients and be considered independent.

[1] *See, Appendix II for ICC definition from the SEC.*

## Recent Regulatory Updates

In October 2020, the SEC adopted amendments to certain auditor independence requirements in Rule 2-01 which governs independence requirements for the aforementioned RIAs ("Amendments"). The amendments modernize the rules and "more effectively focus the analysis on relationships and services that may pose threats to an auditor's objectivity and impartiality." The Final Rule and the adopting press release provide helpful examples to inform the application of the Amendments.[2]

**"These modernized auditor independence requirements will increase investor protection by focusing audit clients, audit committees, and auditors on areas that may threaten an auditor's objectivity and impartiality..."**

-Jay Clayton, Former SEC Chairman

By adopting the Amendments, the SEC seeks to increase investor protection by focusing the auditor independence rules (and thereby the attention of audit clients, audit committees and auditors) on relationships and services that are more likely to jeopardize the objectivity and impartiality of auditors, while avoiding potentially time-consuming audit committee review of technical rule violations and similar non-substantive matters. The Amendments are particularly helpful for private equity firms and investment companies with numerous portfolio companies and investments. Below are a few, but not all, of the changes that impact private fund clients:

- Address potential independence issues arising when portfolio companies with a common investment advisor, or investment companies within the same investment company complex, have engaged an audit firm to provide audit and non-audit services that could impair the independence of the audit firm;
- Shorten the IPO look-back period for domestic first-time filers in assessing compliance with the independence requirements; and
- Introduce a transition framework to address inadvertent independence violations that only arise as a result of mergers or acquisitions.

## Independence Issues Involving Affiliated Sister Entities

The Amendments amend the definitions of "affiliate of the audit client," in Rule 2-01(f)(4), and "investment company complex," in Rule 2-01(f)(14), to incorporate a dual materiality threshold such that a sister entity will be included as an affiliate of the audit client if the sister and the entity under audit are each material to the controlling entity. If either the sister entity or the entity under audit is not material to the controlling entity, then the sister entity will not be deemed to be an affiliate of the audit client. As a result, the Amendments will address and resolve certain auditor independence issues that private equity funds, investment companies and their affiliates currently face as a result of relationships and services that do not ultimately jeopardize the objectivity and impartiality of the audit firm.

In relation to sister entities within the same investment company complex, the Amendments apply the dual materiality threshold with respect to sister investment advisers or sponsors with a common controlling entity, but the SEC has clarified that the dual materiality threshold will not apply to sister investment companies under the control of a shared investment adviser or sponsor. As a result, such entities should continue to be included as part of the investment company complex in evaluating the auditor's independence, regardless of materiality.

## IPO Look-Back Period

The Amendments also amend the definition of "audit and professional engagement period," in Rule 2-01(f)(5)(iii), to shorten the look-back period for domestic first-time filers to one year, rather than covering all periods included in the issuer's registration statement (which can be up to three years). The result of this amendment is that all first-time filers (i.e., domestic issuers and foreign private issuers) are treated similarly for purposes of the independence requirements under Rule 2-01. This is especially important for entities which may become public under a Special Purpose Acquisition Company or SPAC merger.

[2] *See SEC adopting release for the new rules at www.sec.gov/rules/final/2020/33-10876.pdf and the related Press Release entitled "SEC Updates Auditor Independence" at www.sec.gov/news/press-release/2020-261*

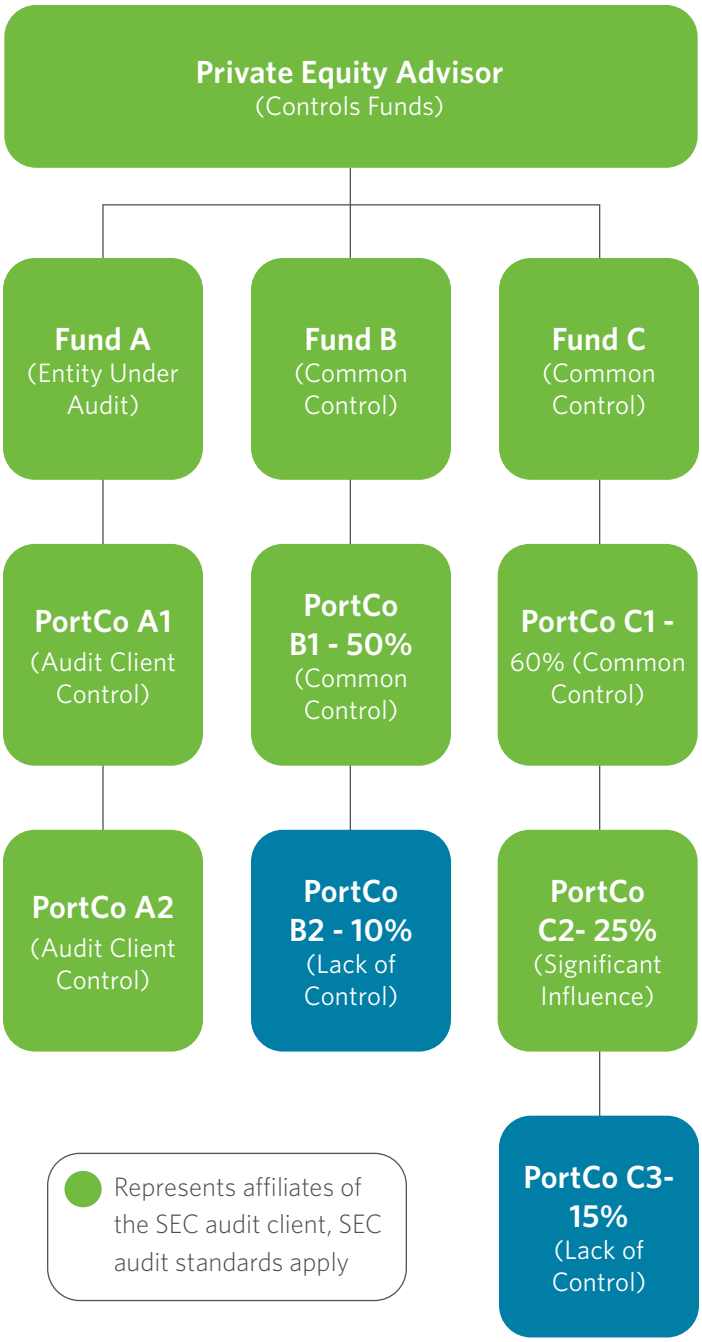
## Transition Framework for Mergers and Acquisitions

The Amendments also introduce a transition framework to address inadvertent independence violations arising only as a result of a merger or acquisition under circumstances in which the services or relationships that are the basis for the violation would not have violated applicable independence standards prior to the corporate event. Under amended Rule 2-01(e), an auditor's independence will not be impaired if an audit client engages in a merger or acquisition transaction resulting in a service or relationship that would otherwise be inconsistent with Rule 2-01 if:

- the auditor has been in compliance with the applicable independence standards related to the services or relationships when the services or relationships originated and throughout the period in which the applicable independence standards apply;
- the auditor addresses such services or relationships promptly under relevant circumstances as a result of the occurrence of the merger or acquisition; and
- the auditor has in place a quality control system as described in Rule 2-01(d)(3) that has the following features: (i) procedures and controls that monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition; and (ii) procedures and controls that allow for prompt identification of potential violations after an initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the merger or acquisition.

## What does this mean for PE Funds and Portfolio Companies?

If a private equity fund is subject to SEC independence rules, the auditor cannot provide prohibited services to any portfolio company that roll up into that fund's financial statements, assuming it is **1) controlled by the advisor** and **2) material to the advisor.** Below is an example of a private equity advisor and its ICC:



**When applying this definition, the following should be noted:**

- Control is presumed if there is more than 50 percent ownership interest. Control also may exist when there is less than 50 percent ownership interest if there are other conditions through which control could be exercised, e.g., board rights, veto rights, a contract, etc.
- Significant influence is presumed if there is 20 percent or more ownership interest but less than 50 percent ownership interest or if board rights or similar features are 20 percent or greater but less than 50 percent.
- An investment is deemed material if the investment in the investee is 5 percent or more of the private equity group's total assets or fund that is subject to SEC rules. If an investment is not yet material, consideration should be given to the likelihood that an affiliate may become material because of changes in the value of the investee.

This rule applies whether the portfolio companies are reported at fair value or are consolidated. It should be noted, however, that there is a "not subject to audit" exception which can be applied to certain brother/sister entities of a portfolio company which are deemed affiliates (e.g., PortCo B1 and PortCo C1). For entities which meet the "not subject to audit" exception, audit firms are allowed to perform certain conditionally permissible services:

- Bookkeeping or other services related to the audit client's accounting records or financial statements, e.g., preparing financial statements or tax provisions and providing valuation or tax provision templates;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services.

The "not subject to audit" exception cannot be applied to the following categorically prohibited services:

- Management or human resources functions, e.g., executive searches
- Loaned staffing arrangements
- Litigation support

**See table on next page for further examples and application within the ICC above.**

| Comparison of Audit Independence Rules for Non-Audit Services | | | | |
|---|---|---|---|---|
| Yes = Permissible service<br>No = Service violates independence standards (SEC or AICPA) | Audit client subject to SEC independence standards & downstream affiliates (Advisor, Fund A, PortCo A1/A2) | Affiliates of the portfolio company not audited by the firm (Fund B/C and PortCos) | Nonpublic portfolio company & downstream affiliates (Advisor, Fund A, PortCo A1/A2) | Affiliates of the nonpublic portfolio company not audited by the firm (Fund B/C and PortCos) |
| **Forensic Accounting (excluding litigation support)** | Yes | Yes | Yes | Yes |
| **Tax Services** | | | | |
| Tax Return Preparation and Review | Yes | Yes | Yes | Yes |
| Tax services for officer or director who acts in an Financial Reporting Oversight Role (FROR) | No | Yes | Yes | Yes |
| Tax services for refunds of amended returns for a contingent fee | No | No | Consult (1) | Consult (1) |
| **M&A or Transaction Support (2)** | | | | |
| Due diligence | Yes | Yes | Yes | Yes |
| **Bookkeeping** | | | | |
| Bookkeeping or drafting financial statements | No | Yes(4) | Yes(3) | Yes |
| **Valuations, Appraisals or Fairness** | | | | |
| Financial reporting – purchase price allocations, goodwill or intangible impairment | No | Yes | No | Yes |
| **Internal Audit Services** | | | | |
| Internal audit services based on specific agreed-upon procedures – subject to firm's quality control provisions and a deliverable work product | No | Consult(5) | Consult(5) | Yes |
| **Information System Design & Installation** | | | | |
| Install information system with access to source code | No | Yes | No | Yes |
| Install off-the-shelf system | No | Yes | Yes | Yes |
| Project management services | No | No | No | Yes |

(1) Contingent fees are complex and only permitted in certain instances. Discuss with independence team on a case by case basis.

(2) Beyond due diligence services, there are many additional potential M&A services for which the relevant independence considerations to are complex and are beyond the scope of this analysis

(3) If the bookkeeping services will result in a set of financial statements or there is financial statement preparation, the client must:

- Approve all account classifications;
- Provide source documents to the member so that the member can prepare journal entries;
- Take responsibility for the results of the member's services, e.g., financial statements; and
- Establish and maintain internal controls over the member's bookkeeping activities.

(4) SEC rules prohibit the performance of these services to an audit client whenever the auditor expects that the results of those services will later be subject to the firm's audit procedures.

(5) Often IA is considered a management function, and there needs to be certain safeguards in place for the service to be permissible. Discuss with independence team on a case by case basis.

# Conclusion

In the end, maintaining auditor independence in a private equity environment can be particularly challenging given the significant number of entities considered to be under common control and within the ICC. First and foremost, independence is a shared responsibility between the auditor and management. This requires a heightened level of communication between the auditor and the private equity fund management team regarding matters such as non-audit services. It is equally important there be heightened two-way communication between private equity fund management and its portfolio companies regarding these matters.

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## *Appendix I*

**Non-audit services.** An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

*i.* ***Bookkeeping or other services related to the accounting records or financial statements of the audit client.*** Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:

- ***A.*** Maintaining or preparing the audit client's accounting records;
- ***B.*** Preparing the audit client's financial statements that are filed with the Commission or that form the basis of financial statements filed with the Commission; or
- ***C.*** Preparing or originating source data underlying the audit client's financial statements.

*ii.* ***Financial information systems design and implementation.*** Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:

- ***A.*** Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network; or
- ***B.*** Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole.

*iii.* ***Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.*** Any appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

*iv.* ***Actuarial services.*** Any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

*v.* ***Internal audit outsourcing services***. Any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements, for an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

*vi.* ***Management functions.*** Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

*vii.* ***Human resources.***

- ***A.*** Searching for or seeking out prospective candidates for managerial, executive, or director positions;
- ***B.*** Engaging in psychological testing, or other formal testing or evaluation programs;
- ***C.*** Undertaking reference checks of prospective candidates for an executive or director position;
- ***D.*** Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or
- ***E.*** Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

*viii.* ***Broker-dealer, investment adviser, or investment banking services.*** Acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

*ix.* ***Legal services.*** Providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

*x.* ***Expert services unrelated to the audit.*** Providing an expert opinion or other expert service for an audit client, or an audit client's legal representative, for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. In any litigation or regulatory or administrative proceeding or investigation, an accountant's independence shall not be deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.

Independence standards for auditors of Private Equity Funds also create additional challenges with respect to services the auditor may render to portfolio companies of the Private Equity Fund audit client.

## *Appendix II*

***SEC Definition of Investment Company Complex (SEC Website)***

Reg. § 210.2-01(f)(16)(i) "Investment Company Complex" includes:

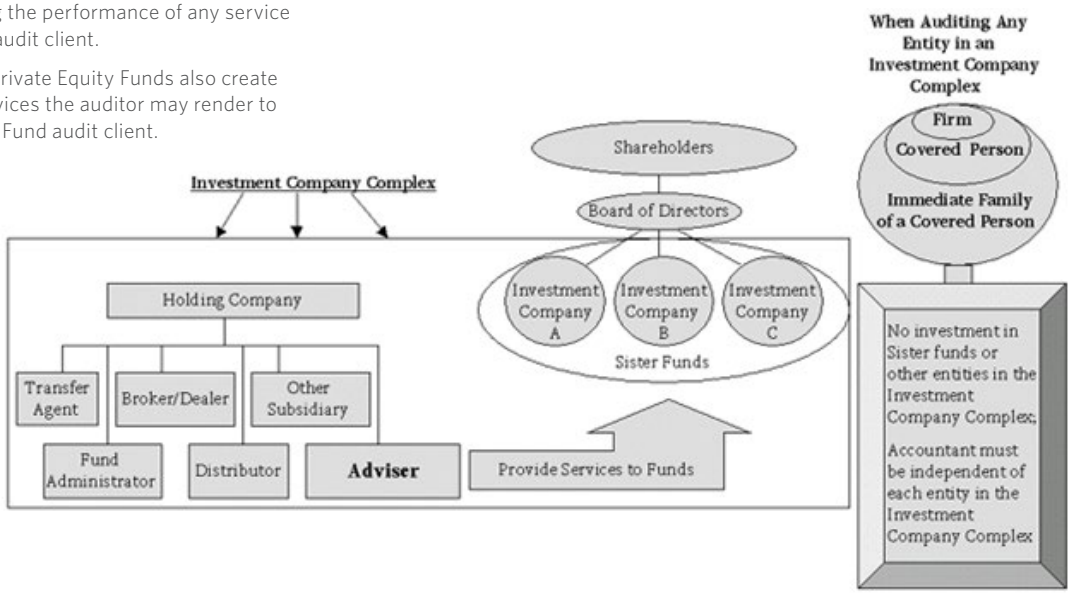
***A.*** An investment company and its investment adviser or sponsor;

***B.*** any entity controlled by, under common control with, or controlling the investment adviser or sponsor in paragraph (f)(16)(A) of this section; or

***C.*** any 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 that has an investment adviser or sponsor included in this definition by either subparagraph (f)(16)(A) or (f)(16)(B)

(ii) 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.

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

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