January 20, 2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Reference: File No. S7-43-11

Dear Ms. Murphy:

PricewaterhouseCoopers LLP ("PwC") appreciates the opportunity to share its perspectives with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to the request for comments on the rules to be reviewed in accordance with the requirements of the Regulatory Flexibility Act ("RFA").

In this letter, we provide our general observations on the SEC's *Revision of the Commission's Auditor Independence Requirements* (17 CFR 210.2-01, 17 CFR 240.14a-101), as approved by the Commission on November 21, 2000. In particular, our comments focus on those elements of the auditor independence rules which, in our experience, have had a significant economic impact on small entities over the ten year period subsequent to the rules' publication.

I. Introduction and Background

The Commission amended Rule 2-01 of Regulation S-X under the Securities Exchange Act of 1934 to modernize its guidance for determining whether an accountant is independent of its audit client in view of certain interests and relationships the accountant may have with the audit client or its affiliates.

Among the provisions of the Commission's auditor independence rules that, in our view, have had the most significant economic impact on smaller entities, are those relating to the requirements that independence be maintained 1) during the "audit and professional engagement period," and 2) with respect to the audit client and each of the audit client's "affiliates" when those provisions are applied to a private company offering securities in the U.S. securities markets.

The Audit and Professional Engagement Period Requirement and Affiliate Rule

SEC independence rules define the "audit and professional engagement period" ("APEP") to encompass not only the period of the accountant's engagement to perform the audit, but also those periods covered by the financial statements under examination.

"Affiliates of the audit client," as defined by the Commission, include those entities, among others, that are under common control with the audit client.

II. Impact of the Affiliate Rule and APEP Requirements on Small Entities - Private Equity Scenario

Although the affiliate and APEP requirements of the Commission's independence rules generally have far-reaching effects that pose formidable challenges with respect to *any* SEC audit client and its auditor, the significance of their impact, including the operational complexity that ensues for smaller companies, are perhaps best exemplified by considering portfolio company audit clients within private equity organizations - specifically those portfolio companies that ultimately intend to register their securities with the SEC. In private equity organizations, it is typical that there are several auditors throughout a broad network of portfolio companies that are not consolidated into a registrant's financial statements. It is also typical that individual entities within such networks will utilize public accounting firms to provide non-audit services to assist them in addressing a wide variety of business issues and initiatives.

The confluence of the APEP and affiliate rules necessitate the auditor of a portfolio company that desires to issue securities in the U.S. public market to look back over three years across a wide group of entities to assess its independence to perform an audit in accordance with Public Company Accounting Oversight Board ("PCAOB") standards. This is particularly challenging in a private equity environment given the significant number of entities under common control; entities that were not originally considered affiliates during those three years (under applicable professional standards in effect during this period). They only *become affiliates* and SEC independence rules apply at the time the portfolio company is required to undergo a PCAOB audit for the offering. As a result, it is common that portfolio company auditors discover situations that are violations of the SEC independence rules when performing an analysis of the look-back period, resulting in circumstances in which an entity's choice of quality auditors is limited. Such situations may serve to delay or prevent portfolio companies from obtaining the capital needed to finance early to mid-stage growth, develop or enhance product/service offerings, or meet other strategic initiatives that can be satisfied by going public.

III. Illustrative Examples

By way of example, assume that controlled Portfolio Company A intends to pursue an initial public offering (IPO). For the purpose of applying the Commission's affiliate rule, the auditor of Company A's financial statements, to be included in its filing with the SEC, must be independent of Company A and *all* of its affiliates (as defined by the Commission's rules). Company A's affiliates, for example, would include (but not be limited to) the private equity fund that controls Company A; the controlling private equity firm, and its parent; all other private equity funds under common control of the private equity firm or its parent; and, all other portfolio companies

controlled by the other private equity funds of the controlling private equity firm ("sister entities").

As noted above, the period during which Company A's auditor must be independent includes the period under audit (the "look-back" period). Given that Company A's filing with the Commission will include three years of audited financial information, its auditors must be independent of Company A and all of its affiliates, not only during the period of the audit engagement, but retrospectively - during the three year look-back period. Accordingly, before Company A can retain an accounting firm as its auditor, a retrospective evaluation must be undertaken of relationships between the firm and Company A (including its affiliates).

Note that the look-back period was, at that time, a period during which SEC independence was not required of the proposing auditor. That is, the firm was either providing audit services to Company A in accordance with generally accepted auditing standards (requiring independence under relevant professional standards other than those of the SEC), or was not otherwise obligated to maintain its independence of Company A.

Two types of relationships that we have observed which commonly create conflicts due to the Commission's independence rules are joint business relationships and the provision of non-audit services. Consider the following fact patterns and analyses -

- *Joint Business Relationship (JBR)*

  Fact pattern - During Year 1 of the look-back period, Portfolio Company Z (a sister entity affiliate of Company A) and Company A's existing auditor (Auditor A) enter into an immaterial prime/subcontractor arrangement to provide services to third parties. The arrangement is terminated in Year 2 of the look-back period.

  Analysis - Although this cooperative arrangement was permissible at the time under relevant professional standards, Auditor A is not independent of Company A for purposes of its IPO. Although the JBR has been terminated, was immaterial, and involved a far distant sister company affiliate, it is an impermissible relationship under the Commission's independence rules. A further analysis of the JBR illustrates that an impairment of Auditor A's ability to act with objectivity and without inappropriate influence is doubtful. A JBR generally creates a mutuality of interest between the auditor and client. In this case, since the JBR no longer exists in Year 3 when Auditor A may be engaged to perform an audit under PCAOB standards for inclusion in the IPO filing, there is no longer a mutuality of interest between the auditor and client. This is the case not only because of the "distance" in the organizational structure between the IPO client and the JBR entity, but largely because the JBR has long since ceased and the risk no longer exists that Auditor A's judgment will be affected by the relationship.

- *Non-audit Service Provision*

  Fact Pattern - Accounting Firm B, Company A's choice to succeed non-independent Auditor A, provided litigation support services (limited scope, short-term assignment) to Portfolio Company X (a sister entity affiliate of Company A) during a two-week time frame in Year 2 of the look-back period.

  Analysis - This non-audit service was permissible at the time it was provided, as Accounting Firm B was not providing a service that imposed an obligation to comply with independence requirements (in fact Firm B was not required to be independent with respect to Company A under any standards at the time the services were provided). Accounting Firm B is nevertheless not considered independent of Company A for purposes of its IPO, as the non-audit service provided during the look-back period, though terminated, limited in scope, and provided to a far distant sister company affiliate, is impermissible under the Commission's independence rules. Although the expert services did create an advocacy relationship between Accounting Firm B and Portfolio Company X during a two week period in Year 2, it is unlikely that Firm B would still be viewed as an advocate of Company X (or A) at the time Company A seeks to engage Firm B as its auditor. Note in fact, that in most cases involving private equity organizations, Company A would be unaware of the existence of sister Portfolio Company X.

These examples share a common theme - that is, matters occurring during the audit period that are inconsistent with the SEC's independence rules may not raise doubts about an auditor's independence. There is precedent in the Commission's rules for an approach whereby potential independence issues can be resolved prior to the engagement of the independent auditor. Through the operation of Regulation S-X 2.01(c)(1)(iii)(B), the auditor does not fail to be independent of its new audit client due to the holding of financial interests during the audit period if those financial interests are disposed of prior to the commencement of the professional engagement period. In a similar way, PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*, provides that an otherwise impermissible personal tax service for an individual in a financial reporting oversight role would not impair the auditor's independence if terminated prior to the commencement of the professional engagement period to perform an examination under PCAOB standards.

Given consideration to both illustrative examples, it is unlikely that a reasonable investor,[1] with knowledge of the facts and circumstances cited above, would conclude that either Auditor A or

[1] SEC Rule 2-01(b), the "general standard" provides that "The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an

Accounting Firm B would be incapable of exercising objective and impartial judgments as auditor. However, the Commission's rules do not provide a flexible framework for addressing facts and circumstances such as those described in the examples above as they do for financial interests; the relationship and non-audit service cited are simply deemed to be violations that impair independence. There is no allowance in the SEC rules to consider mitigating factors such as insignificance or immateriality in these situations. Nor is there a provision for a "reasonable investor" evaluation to be undertaken by Portfolio Company A's audit committee, considered in conjunction with the SEC's "general standard" (i.e., the accountant would not be auditing its own work, no mutuality of interests exists, etc.).[2] In addition, as previously stated, it is not unusual for several different public accounting firms to be providing non-audit services to numerous entities within a private equity network based on the entities' desire to address critical business initiatives and issues. Thus, it can be difficult for an entity that wishes to access the capital markets to select the most qualified auditor based on the application of the SEC's current independence rules. Accordingly, Portfolio Company A's choice of auditors has been limited in each of these scenarios; and the judgment of its audit committee has been preempted. The end result is unnecessary additional costs, time and effort, due to the expansive scope of the SEC's affiliate and APEP requirements.

IV. Conclusion

On the basis of the foregoing, we have observed that the construct of the Commission's independence rules (in particular, the requirement to be independent during the period covered by the financial statements with respect to "sister entity" affiliates - without regard to significance or materiality) does, in too many situations, act to inhibit or restrict choices of audit firms and non-audit service providers available to smaller entities. These limitations, where they exist, can impair the ability of smaller entities to obtain the capital needed to finance early to mid-stage growth, to undertake product/service enhancement and development, and to eventually "go public." Further, they serve to undermine the authority of independent audit committees - established pursuant to SEC rules, self-regulatory organizations and mandated by Congress, to oversee auditor relationships. In sum, our observations suggest that the Commission's independence requirements can, and sometimes do, have significant and detrimental economic effects on smaller entities, investors, and the U.S. capital markets.

In addition, we note that these challenges are not nearly as significant for a non-U.S. company that desires to offer shares in the U.S. A prospective foreign private issuer's auditor is only

---

accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."

[2] Rule 2-01 also provides that " In considering this [general] standard, the Commission looks in the first instance to whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client."

required to adhere to the SEC independence rules for the most recent of the three years of financial statements included in a registration statement filed with the SEC. Extending this consideration to U.S. companies filing to offer securities in the U.S. securities markets, would make it easier to obtain financing, while relying upon a framework that already exists within the SEC's rules to provide investor protection.

The requirements of the RFA, in part, to "...determine whether such rules should be continued without change, or should be amended or rescinded ..." present the Commission with a unique opportunity: to reflect upon the extent to which the independence rules issued in November, 2000 continue to ensure that the requisite level of auditor independence is maintained, while upholding investor protection, without imposing undue complexity or costly and unnecessarily burdensome requirements. We support the Commission's efforts in undertaking this review, one that would, in our view, benefit by giving consideration to the observations of those who have "lived with" these requirements in real world settings, including the experiences of the Commission in assisting registrants and accountants with operationalizing the rules.

*****

We would be pleased to provide further information, or respond to any questions the Commission or the staff may have in the course of conducting its RFA review. We thank the Commission for affording us the opportunity to participate constructively in this process. Please feel free to contact Michael Deniszczuck at (201) 521-4239 regarding this submission.

Respectfully submitted,

PricewaterhouseCoopers LLP