

SEC/PCAOB Independence Rules for Non-Issuer Audit and Attestation Engagements

This alert, issued jointly by the Center for Audit Quality (CAQ) and the American Institute of Certified Public Accountants (AICPA), is intended to provide audit firms with an overview of the independence rules of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) applicable with respect to financial statement audit and attestation engagements undertaken for the following non-issuers:

- Non-issuer broker-dealers that are registered with the SEC as a broker or dealer; and
- Where the engagement(s) is subject to the requirements of SEC Rule 206(4)-2 (17 CFR 275.206(4)-2) (“Custody Rule”), SEC-registered and state-registered investment advisers, related party custodians, or private funds (e.g., pooled investment vehicles).

Note that while SEC or PCAOB independence rules may apply with respect to non-issuer audit and attestation engagements other than those listed above (e.g., engagements required by the Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC)), such engagements are not the intended focus of this alert, but are briefly covered for informational purposes.

This alert serves as a follow-up to the independence guidance provided in the CAQ and AICPA’s original joint alert ([Alert #2014-6, “Updates to SEC and CFTC Regulations and Related Audit and Attestation Reports of Brokers and Dealers and Futures Commission Merchants, Including Those That Are Dually-Registered”](#)), issued May 12, 2014. This alert also provides relevant guidance as reflected in the PCAOB’s [“Staff Guidance for Auditors of SEC-Registered Brokers and Dealers.”](#) and in light of the PCAOB’s recent issuance of its [“Third Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers.”](#) wherein the PCAOB expressed concern over the continued high number of independence findings related to audits of broker-dealers.

This alert addresses the following:

1. Applicability of SEC Independence Rules
2. Bookkeeping Services, Including Financial Statement Preparation
3. Applicability of PCAOB Independence Rules
4. Other Engagements Subject to SEC or PCAOB Independence Rules

Finally, while the alert highlights areas of focus, it should not be relied upon as definitive or all-inclusive and should be read together with the applicable rules, regulatory updates, standards, and guidance in their entirety.

1. Applicability of SEC Independence Rules

Although the source of the requirement differs, the SEC independence rules to be followed are the same for both non-issuer broker-dealer audit and attestation engagements and engagements subject to the Custody Rule. For non-issuer broker-dealer audit and attestation engagements, SEC Rule 17a-5, *Broker-Dealer Reports* (17 CFR 240.17a-5) requires that the auditor be independent in accordance with the provisions of SEC Rule 2-01 (17 CFR 210.201). The Custody Rule also requires that the auditor be independent in accordance with the provisions of SEC Rule 2-01(b) and (c). Certain states have adopted the requirement to comply with the SEC custody rule, thereby also requiring the auditors to comply with SEC independence rules. As a

result, auditors may be subject to SEC independence rules when performing such engagements for investment advisers not registered with the SEC but solely with a particular state(s).

This means that for both non-issuer broker-dealer audit and attestation engagements and engagements subject to the Custody Rule, the auditor is required to follow all of the SEC independence rules set forth in Rule 2-01(b) and (c), except those rules that apply only to engagements for “issuers”. Specifically, the following SEC independence rules *do* apply to such audit and attestation engagements for non-issuers:

- General standard of auditor independence (Rule 2-01(b))
- Financial relationships (Rule 2-01(c)(1))
- Employment relationships (Rule 2-01(c)(2)(i)-(iii)(A) and (c)(2)(iv))
- Business relationships (Rule 2-01(c)(3))
- Non-audit services (Rule 2-01(c)(4))
- Contingent fees/commissions (Rule 2-01(c)(5))

Pursuant to Rule 2-01(b), the auditor will not be recognized as independent with respect to an audit client if the auditor is not, or if a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor’s engagement. In determining whether an auditor is independent, the SEC will consider all relevant circumstances, including all relationships between the auditor and the audit client, and not just those relating to reports filed with the SEC. The standard is predicated largely on whether a relationship or the provision of a service:

1. Creates a mutual or conflicting interest between the auditor and the audit client;
2. Places the auditor in the position of auditing his or her own work;
3. Results in the auditor acting as management or an employee of the audit client; or
4. Places the auditor in a position of being an advocate for the audit client.

Conversely, the following SEC independence rules *do not* apply to non-issuer broker-dealer audit and attestation engagements and engagements conducted pursuant to the Custody Rule, since they only apply to issuer audits:¹

- Employment cooling-off for former members of the audit engagement team (Rule 2-01(c)(2)(iii)(B)-(C))
- Partner rotation (Rule 2-01(c)(6))
- Audit committee administration of the engagement (i.e., audit committee pre-approval) (Rule 2-01(c)(7))
- Audit partner compensation (Rule 2-01(c)(8))

As a reminder, the non-audit services prohibitions in SEC Rule 2-01(c)(4) cover certain services that are prohibited outright (herein referred to as “categorically” prohibited), as well as other services that are prohibited unless they are not subject to audit² (or “conditionally” prohibited).

¹ See, Office of the Chief Accountant: Application of the Commission’s Rules on Auditor Independence, Frequently Asked Questions, Broker-Dealer and Investment Advisory Section ([link](#)).

² See, Office of the Chief Accountant: Application of the Commission’s Rules on Auditor Independence, Frequently Asked Questions, Prohibited and Non-audit Services, Question 4, in which the SEC states that there is a rebuttable presumption that the prohibited services will be subject to audit procedures ([link](#)).

The categorically prohibited services covered in the rule are as follows:

- Management functions (Rule 2-01(c)(4)(vi))
- Human resources (Rule 2-01(c)(4)(vii))
- Broker-dealer, investment advisor, or investment banking services (Rule 2-01(c)(4)(viii))
- Legal services (Rule 2-01(c)(4)(ix))
- Expert services unrelated to the audit (Rule 2-01(c)(4)(x))

The conditionally prohibited services covered in the rule are as follows:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client (Rule 2-01(c)(4)(i))
- Financial information systems design and implementation (Rule 2-01(c)(4)(ii))
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports (Rule 2-01(c)(4)(iii))
- Actuarial services (Rule 2-01(c)(4)(iv))
- Internal audit outsourcing services (Rule 2-01(c)(4)(v))

2. Bookkeeping Services, Including Financial Statement Preparation

Both the PCAOB and SEC have focused on the independence prohibitions relating to financial statement preparation (a conditionally prohibited service) for an audit client. In the aforementioned [“Third Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers,”](#) the PCAOB cited the fact that firms were found to have prepared, or assisted in the preparation of, the financial statements or supporting schedules required by SEC Rule 17a-5. In addition, some firms also prepared journal entries or source data underlying the financial statements of the brokers and dealers, each of which is prohibited under the SEC independence rules.

The SEC made specific mention of the prohibition on financial statement preparation in a speech presented by its staff at the [PCAOB Forum on Auditing Smaller Broker-Dealers \(May 28, 2014\)](#).³ The SEC staff indicated that auditors should not, among other things, provide typing and word processing services, or financial statement templates that are not publicly available to the audit client as these would be considered prohibited financial statement preparation services.

Given this focus, audit firms are encouraged to review their policies and procedures as it relates to the SEC prohibition on financial statement preparation services (which may include financial statement production services) and to remind their audit engagement teams on engagements that are the subject of this alert that the activities described above are the responsibility of client management. The responsibility of the independent auditor is to express an opinion on the financial statements.

3. Applicability of PCAOB Independence Rules

SEC independence rules, as cited above, apply equally to non-issuer broker-dealer engagements and engagements subject to the Custody Rule. With respect to such engagements, PCAOB

³ Similar presentations were present at other PCAOB’s forums on Auditing in the Small Business Environment and Auditing Smaller Broker-Dealers ([link](#)).

independence rules only apply to non-issuer broker-dealer engagements, not to engagements conducted pursuant to the Custody Rule. The basis for this application lies in the underlying standards under which these engagements are performed. SEC Rule 17a-5 requires that non-issuer broker-dealer engagements be conducted in accordance with the standards of the PCAOB effective for broker-dealer fiscal years ending after June 1, 2014, whereas engagements conducted pursuant to the Custody Rule are conducted in accordance with standards promulgated by the AICPA (i.e., U.S. generally accepted auditing standards and AICPA attestation standards).

The following PCAOB independence rules are applicable to non-issuer broker-dealer audit engagements:

- Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the PCAOB Rules*
- Rule 3520, *Auditor Independence*
- Rule 3521, *Contingent Fees*
- Rule 3522, *Tax Transactions*
- Rule 3526, *Communications with Audit Committees Concerning Independence*
- Rule 3500T, *Interim Ethics and Independence Standards*, including
 - ISB No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*
 - ISB No. 3, *Employment with Audit Clients*
 - ISB Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)*

Further, the following PCAOB independence rules *do not apply* to non-issuer broker-dealer engagements:

- Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*
- Rule 3524, *Audit Committee Pre-Approval of Certain Tax Services*
- Rule 3525, *Audit Committee Pre-approval of Non-Audit Services Related to Internal Control Over Financial Reporting*

4. *Other Engagements Subject to SEC or PCAOB Independence Rules*

Audit firms are reminded that non-issuer audit and attestation engagements subject to SEC or PCAOB independence rules are not limited to non-issuer broker-dealer and engagements conducted pursuant to the Custody Rule. For example, Regulation AB requires that servicer compliance attestation reports be filed with the SEC, thereby requiring compliance with certain SEC independence rules.

Further, other regulators such as the CFTC and FDIC require compliance with certain SEC or PCAOB independence rules, even where the SEC or PCAOB do not otherwise have jurisdiction over such engagements. The CFTC requires audits of futures commission merchants to be conducted in accordance with the standards of the PCAOB and considers compliance with the auditor independence rules applicable to non-issuer broker-dealer engagements to be in compliance with the CFTC's independence requirements. The FDIC requires auditors who perform audit and attestation services under Part 363 (for a depository institution with respect to any fiscal year in which its consolidated total assets as of the beginning of such fiscal year are \$500 million or more) to comply with the independence standards and interpretations of the AICPA, PCAOB, and SEC.

Summary

In summary, financial statement audit and attestation engagements undertaken pursuant to SEC reporting requirements for 1) non-issuer broker-dealers registered with the SEC as a broker or dealer, and 2) SEC-registered and state-registered investment advisers, related party custodians, or private funds (e.g., pooled investment vehicles), where the engagement(s) is subject to the requirements of the Custody Rule, require compliance with all independence rules pursuant to SEC Rule 2-01 except for those rules that specifically apply to issuers. Further, non-issuer broker-dealer engagements also require compliance with PCAOB independence rules (and more specifically, all of those rules except for Rules 3523, 3524, and 3525).

Audit firms should refresh their understanding of the applicable independence rules as outlined in this alert. Further, firms should continue to assess services and relationships with the types of clients that are the subject of this alert to ensure permissibility within the rules, as well as keep open lines of communication with management and the audit committee in order that all parties have a part in understanding matters that may bear on the audit firm's independence.