The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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# SEC Adopts Amendments to Loan Provision; ICI Member Call Scheduled for July 11 at 2:00 pm (Eastern Time)

[31823]

June 24, 2019 TO: ICI Members
Investment Company Directors SUBJECTS: Audit and Attest
Audit Committees
Compliance
Fund Accounting & Financial Reporting RE: SEC Adopts Amendments to Loan Provision; ICI Member Call Scheduled for July 11 at 2:00 pm (Eastern Time)

The Securities and Exchange Commission recently adopted amendments to the "loan provision" of the auditor independence rules, which governs when an auditor is independent if it has a lending relationship with certain shareholders of an audit client.[1] As previously reported, the SEC amended the provision after realizing that there are certain scenarios that do not impair an auditor's impartiality or objectivity despite a technical failure to comply with the provision.[2] The amendments take effect 90 days after publication in the Federal Register and largely are consistent with the SEC's proposal, which ICI strongly supported. Specifically, the amendments:

- Focus the analysis on beneficial ownership, rather than both beneficial ownership and record ownership;
- Replace the existing 10 percent bright line ownership test with a "significant influence" test;
- Add a "known through reasonable inquiry standard" to identify beneficial owners of the audit client's equity securities; and
- Exclude from the definition of "audit client" for a fund under audit, any other funds (including registered funds, private funds, foreign funds, and commodity pools).

ICI will hold a member call to discuss the Adopting Release on July 11 at 2:00 pm (Eastern Time). Please contact Ruth Tadesse at rtadesse@ici.org to receive dial-in information. If you have any questions, please contact Greg Smith at smith@ici.org or Kenneth Fang at kenneth.fang@ici.org.

Below we provide background and a brief summary of the Adopting Release.

## I. Background

The loan rule currently provides that an auditor is not independent when (a) the accounting firm, (b) any covered person in the accounting firm (*e.g.*, the audit engagement team and those in the chain of command), or (c) any of the covered person's immediate family members has any loan to or from (i) an audit client, (ii) an audit client's officers, directors, or (iii) record or beneficial owners of more than 10 percent of the audit client's equity securities.[3] The term "audit client" includes any affiliate of the entity whose financial statements are being audited, and "affiliate" for this purpose includes any entities that control, are controlled by, or are under common control with the audit client.[4] As a result, an audit firm generally is not independent if it has a lending relationship with a record or beneficial owner of more than 10 percent of either (a) the audit client's equity securities or (b) any entity that controls, is controlled by, or is under common control with the audit client.

In 2016, certain funds and investment advisers disclosed compliance concerns relating to the loan provision. These disclosures indicated, for example, that a fund's auditor had relationships with lenders who also own of record more than 10 percent of one or more funds in the investment company complex. The concerns raise potentially disruptive challenges for funds, as funds that are continuously offered must maintain registration statements with updated financial statements and registered funds must transmit annually to shareholders and file with the SEC financial statements. In each case, *independent* public accountants must audit the financial statements. Thus, audits from public accountants that are not independent could result in affected funds not being able to offer or sell shares, investors that cannot rely on affected financial statements, or funds having to incur the costs of re-audits.

To address the concerns, the SEC staff issued a no-action letter providing relief from the loan provision's independence requirements under certain specified circumstances.[5] The no-action letter, originally set to expire 18 months after issuance, was extended until the effective date of any amendments to the loan provision intended to address the concerns expressed in the no-action letter.[6] Last year, the Commission proposed rules to permanently address the loan provision challenges.

## II. Adopting Release

The amended rule is intended to more effectively identify lending relationships that could impair an auditor's objectivity and impartiality and exclude attenuated relationships that do not. It applies broadly to entities beyond the investment management industry, including operating companies and registered broker-dealers.

### Focuses Analysis on Beneficial Ownership

The amended rule eliminates record ownership violations, so the loan provision applies only to beneficial owners of the audit client's equity securities.[7] Consistent with the proposal, the Commission believes that tailoring the loan provision to focus only on beneficial ownership more effectively captures shareholders "having a special and influential role with the issuer" and therefore have stronger incentives to influence the auditor's report.[8]

In the Adopting Release, the Commission also clarifies the term "beneficial owner." First, it states that financial intermediaries who hold shares as record owner and have limited authority to make or direct voting or investment decisions are not beneficial owners under the loan provision.[9] Second, it states that financial intermediaries that take steps to remove their discretion over the voting or disposition of shares generally are not beneficial

owners under the loan provision. These steps could include: (i) mirror voting shares (voting its shares in the same proportion as the vote of all other shareholders); (ii) holding shares in an irrevocable trust with no discretion to vote the shares; (iii) passing the voting of shares to an unaffiliated third-party; and (iv) relinquishing rights to vote the shares. Finally, the Commission reiterates that entities that are under common control, or controlled by, the beneficial owner of the audit client's equity securities are excluded from the scope of the loan provision when such beneficial owner has significant influence over the audit client.

**Uses a Significant Influence Test**

As proposed, the amended rule eliminates the current bright-line 10 percent test in favor of a "significant influence" test similar to that referenced in other parts of the Commission's auditor independence rules.[10] In particular, the amended rule looks at whether a lender has the ability to exercise significant influence over the policies and management of an audit client. To determine significant influence, the Commission would look at guidance under US generally accepted accounting principles that says that significant influence over the operating and financial policies of an audit client could be indicated through: (a) representation on the board of directors; (b) participation in policy-making decisions; (c) material intra-entity transactions; (d) interchange of managerial personnel; or (e) technological dependency.[11] That guidance also includes a rebuttable presumption that a lender owning 20 percent or more of an audit client's voting securities has the ability to exercise significant influence over the audit client's operating and financial policies.

In the fund context, the SEC believes that the operating and financial policies relevant to the significant influence test include the fund's investment policies and day-to-day portfolio management policies, including those governing the selection, purchase and sale, and the valuation of investments, and the distribution of income and capital gains (collectively, "portfolio management processes"). It restates that audit firms could analyze whether significant influence over the fund's portfolio management processes exists based on an evaluation of the fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements, among any other relevant factors.[12] The Commission states that where the terms of an advisory agreement grant the adviser significant discretion over the fund's portfolio management processes and the shareholder cannot influence the portfolio management processes, significant influence generally would not exist.[13] Consistent with our recommendation, the Commission adds that, at such point, the significant influence evaluation would be complete unless there is a material change in the fund's governance structure and governing documents. It confirms that this should result even if the shareholder holds 20 percent or more of the fund's equity securities, which otherwise would trigger a rebuttable presumption of significant influence.[14]

**Employs a "Known Through Reasonable Inquiry" Standard**

As proposed, the amended rule adds a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities. Under this standard, beneficial owners of the audit client's equity securities would be assessed only after a reasonable inquiry. Contrary to ICI's recommendation, the Commission did not adopt a "known" standard because it believes that auditors and audit clients should inquire about beneficial owners as a matter of practice when reviewing the audit client's governance structure, governing documents, Commission filings, or other information the audit client prepares. Thus, it does not think the standard would impose an undue burden

in identifying and evaluating beneficial owners of the audit client's equity securities.

**Excludes Other Funds that Would be Considered Affiliates of the Audit Client**

For a fund under audit, the amended rule excludes from the definition of "audit client," any other fund that otherwise would be considered an affiliate of the audit client. It expands the definition of "fund" to include, not only investment companies and private funds relying on an exclusion from registration as an investment company, but also (i) commodity pools that are not investment companies and do not rely on an exclusion and (ii) foreign funds that are part of the investment company complex.[15] The current definition of "audit client" includes all affiliates of the audit client, which broadly encompasses each entity in the investment company complex. Amending the rule to exclude from "audit client" other affiliated funds narrows the entities auditors and audit clients must evaluate. The SEC agrees with commenters, such as ICI, that investors in a fund typically do not possess the ability to influence the policies or management of the other excluded "sister" funds.[16]

**Requests Comment on Other Potential Changes**

Finally, the Adopting Release notes that the SEC received additional comments on the loan provision and the independence rules generally. These comments can be categorized as follows:

- Further changes to the loan provision, but not significant compliance challenges that need to be immediately addressed (*e.g.*, other types of loans that commenters suggested should be excluded from the loan provision, such as student loans);
- Changes broadly impacting the auditor independence rules, including the loan provision (*e.g.*, comments related to the "covered person" and "affiliate of the audit client" definitions); and
- Changes broadly impacting the auditor independence rules, other than the loan provision (*e.g.*, suggestions to narrow the look-back period for domestic initial public offering so that the period is similar to that for foreign private issuers).

In response to these comments the Chairman has directed the SEC staff to formulate recommendations for possible changes on other aspects of the auditor independence rules in a future rulemaking.

Kenneth Fang
Assistant General Counsel

Gregory M. Smith
Senior Director, Fund Accounting and Compliance

**endnotes**

[1] *See* Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Securities Act Release No. 10648 (June 18, 2019) ("Adopting Release"), *available at* https://www.sec.gov/rules/final/2019/33-10648.pdf.

[2] *See* ICI Memorandum No. 31198 (May 7, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31198. *See also* Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Securities Act Release No. 10491 (May 2, 2018), *available at* https://www.sec.gov/rules/proposed/2018/33-10491.pdf.

[3] *See* Rule 2-01(c)(1)(ii)(A) of Regulation S-X.

[4] *See* Rules 2-01(f)(6) and 2-01(f)(4) of Regulation S-X.

[5] *See* Fidelity Management & Research Company, et al. (pub. avail. June 20, 2016), *available at* https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm. For a summary of the no-action letter, *please see* ICI Memorandum No. 29994 (June 22, 2016), *available at* https://www.ici.org/my_ici/memorandum/memo29994.

[6] *See* Fidelity Management & Research Company, et al. (pub. avail. Sept. 22, 2017), *available at* https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm. For a summary of the no-action letter extending the expiration date, *please see* ICI Memorandum No. 30885 (Sept. 25, 2017), *available at* https://www.ici.org/my_ici/memorandum/memo30885.

[7] As a general matter, the Commission clarifies that auditor independence is a shared responsibility between the auditor and the audit client, noting that sharing the responsibility enhances the reliability of the process for identifying beneficial owners.

[8] *See* Adopting Release at 20.

[9] The Commission, however, notes that it is not interpreting Rule 13d-3 under the Securities Exchange Act (defining "beneficial owner" for purposes of Section 13 of the Securities Exchange Act and the rules thereunder), applying the existing standards for determining who is a beneficial owner under Rule 13d-3, or altering those standards.

[10] *See* Rule 2-01(c)(1)(i)(E)(1)(i), (E)(1)(ii), (E)(2), (E)(3), (f)(4)(ii), and (f)(4)(iii) of Regulation S-X.

[11] *See* Financial Account Standards Board, ASC Topic 323, Investments – Equity Method and Joint Ventures. *See* 323-10-15-6 through 323-10-15-11.

[12] In this regard, the Commission notes that auditors should monitor the loan provision on an ongoing basis by reevaluating its determination in response to material changes in the fund's governance structure and governing documents, Commission filings about beneficial owners, or other information that implicates the ability of beneficial owners to exert significant influence of which the audit client or auditor becomes aware. Consistent with ICI's recommendation, the Commission narrowed the scope of the review from "publicly available information about beneficial owners" to "Commission filings about beneficial owners." It does not dictate the frequency and timing of these evaluations, which should be based on the facts and circumstances of the audited entity.

[13] The Commission confirms that significant influence does not necessarily exist when: (i) a shareholder votes on a fund's advisory contract or its fundamental policies on a *pro rata* basis with all holders of the fund; (ii) a shareholder has the ability to remove or

terminate a fund's advisory contract alone; or (iii) an authorized participant or market maker that lends to a fund deposits or receives a basket of assets from an exchange-traded fund. On the other hand, the Commission observes that a shareholder in a private fund that has a side letter agreement that allows for participation in portfolio management processes would likely have significant influence. In addition, the Commission states that holders of a closed-end fund's preferred stock with certain rights may be relevant to the significant influence evaluation depending on facts and circumstances.

[14] Contrary to ICI's recommendation, the Commission did not include a materiality qualifier as part of the significant influence test (*e.g.*, looking at the materiality of the loan to the auditor or covered person or the materiality of the lender's investment in the audit client). It noted several reasons for doing so, including that such a qualifier would scope out a broad range of lending relationships and would not sufficiently address lending relationships. It also stated that permitting a materiality qualifier would cause the inquiry to be affected by fluctuating market conditions (*e.g.*, market conditions could cause changes in the value of assets securing a loan, thereby leading to different determinations at different times of the materiality of a lending relationship). Rather, it stated that the auditor and audit client should consider all relevant circumstances between an auditor and audit client, which includes qualitative and quantitative factors.

[15] *See* Amended Rule 2-01(c)(1)(ii)(A)(2)(ii); Adopting Release at note 15.

[16] The Commission specifically did not exclude downstream affiliates of excluded funds but noted that, for purposes of the loan provision, the exclusion of sister funds from the "audit client" definition excludes entities that would otherwise be included in the audit company definition solely by virtue of their association with an excluded sister fund.

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