The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC Grants No-Action Relief to Auditor Independence Issues

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TO: ACCOUNTING/TREASURERS MEMBERS No. 14-16
CHIEF COMPLIANCE OFFICER COMMITTEE No. 10-16
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 8-16
COMPLIANCE MEMBERS No. 18-16
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 12-16
ETF ADVISORY COMMITTEE No. 12-16
INTERNAL AUDIT COMMITTEE No. 5-16
INVESTMENT COMPANY DIRECTORS No. 17-16
SEC RULES MEMBERS No. 27-16
SMALL FUNDS MEMBERS No. 26-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 12-16 RE: SEC GRANTS NO-ACTION RELIEF TO AUDITOR INDEPENDENCE ISSUES

Earlier this week, the SEC's Division of Investment Management issued a letter providing temporary no-action relief to entities in an "investment company complex" when those entities rely on audit services performed by public accounting firms whose independence might be compromised. [1] The letter specifically addresses auditor independence issues related to the "Loan Provision," as described below, and permits funds, under certain circumstances, to use financial statements audited by audit firms that do not comply with the Loan Provision to meet their regulatory obligations.

Background

Registered funds, including exchange-traded funds, annually must send to shareholders and file with the Commission financial statements audited by independent audit firms. [2] The SEC has set forth strict guidelines establishing when an auditor is deemed "not independent." One particular provision, the "Loan Provision," states that

> [a]n accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has . . . [a]ny loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities. . . [3]

Under the provision, the term “audit client” includes, not only the entity being audited, but any affiliates of the entity and any entity in the investment company complex when the audit client is part of an investment company complex. [4] Therefore, an audit firm may not be independent under the Loan Provision when it has a lending relationship with any entity having a record or beneficial ownership of more than ten percent of an entity in the investment company complex.

Public Company Accounting Oversight Board rules require an audit firm to be independent of its audit clients and to annually affirm its independence in writing to the audit committee of the audit client. The annual communication must include: (a) a written description of all relationships between the audit firm and the audit client that may reasonably bear on independence; (b) a discussion with the client’s audit committee regarding the potential effects of such relationships on independence; and (c) a written affirmation that, as of the date of the communication, the audit firm is independent. [5] Funds and audit committees often rely on these representations annually when evaluating their auditors.

Relief

Recently, audit firms have informed funds that they might not be in compliance with the Loan Provision. The letter provides broad relief for the following scenarios in which an audit firm is in noncompliance with the Loan Provision:

- An institution [6] that has a lending relationship with an audit firm holds of record, for the benefit of its clients or customers, more than ten percent of the shares of a fund;
- An insurance company that has a lending relationship with an audit firm holds more than ten percent of the shares of a fund in separate accounts that it maintains on behalf of its insurance contract holders; and
- An institution that has a lending relationship with an audit firm and acts as an authorized participant or market maker to an ETF and holds of record or beneficially more than ten percent of the shares of the ETF.

The SEC staff also provides relief where an institution with a lending relationship with an audit firm beneficially owns more than ten percent of the shares of an entity (e.g., a closed-end fund) and has taken steps to limit the institution’s discretion to vote those shares (e.g., shares are held in an irrevocable trust without discretion for the institution as to the voting of shares, the institution has agreed to “mirror vote”, [7] the institution has agreed to pass through the vote to an unaffiliated third-party entity, or the institution otherwise has relinquished its right to vote such shares). Additionally, relief would apply when an institution that has a lending relationship with an audit firm beneficially owns more than ten percent of the shares of an entity that is audited by a different audit firm. [8]

In providing relief, the SEC staff relied on several representations, including the audit firm’s representation that, after an evaluation of the impact of the lending relationship on independence, it is able to maintain its impartiality and objectivity with respect to the planning and execution of its audits, and that those responsible for the oversight of the funds have not reached a different conclusion. This representation does not appear to require those responsible for the oversight of the funds to reach a conclusion regarding the auditor’s independence but does restrict relief if they do determine that the auditor is not able to maintain impartiality and objectivity.

In addition, the letter notes the representation that, if one or more matters that could influence the objectivity and impartiality of the independent audit firm (e.g., the election of

trustees or directors or the appointment of an independent auditor) are put before shareholders of an entity in an investment company complex for vote, the entity will make reasonable inquiry as of the record date about the impact of the Loan Provision. If the entity determines as part of that inquiry that an institution exercises discretionary voting authority over more than ten percent of the entity's shares, the entity would not rely on the relief and would take other appropriate action (e.g., engage another audit firm or seek alternate relief). Thus, funds only must make the determination on whether an institution can vote more than ten percent of the entity's shares as of the record date for that matter. In this regard, the SEC staff notes that it expects entities to develop policies and procedures reasonably designed to ensure that they make a reasonable inquiry about the impact, in a manner best suited to their organizations. [9]

Funds that have similar facts and circumstances and encounter any of the scenarios above can rely on the relief without any fund board or audit committee action, so long as:

1. Their audit firm has complied with PCAOB Rule 3526(b)(1) and (2) [10] (requiring audit firms to communicate with audit clients annually regarding their independence) or, with respect to an entity to which PCAOB Rule 3526 does not apply, provide substantially equivalent communications;
2. The non-compliance of the audit firm is with respect to the scenarios described in the letter; and
3. Notwithstanding such non-compliance, the audit firm has concluded that it is objective and impartial with respect to the issues encompassed within the engagement.

The no-action relief is temporary and, notably, will expire in December 2017, unless the SEC staff decides to renew it. The temporary nature of the relief suggests that the SEC may consider rulemaking to modify the Loan Provision. ICI will be engaging with the SEC and its staff on any such potential rulemaking.

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endnotes

[1] 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.

[2] See, e.g., Section 30(e) of the Investment Company Act of 1940 ("1940 Act") and Rule 30e-1 thereunder (requiring registered investment companies to transmit annually to shareholders financial statements audited by an independent public accountant); Form N-1A (requiring audited financial statements to be included or incorporated by reference in open-end registered investment company registration statements); Regulation S-X (setting forth the required content of financial statements of issuers and establishing the qualifications for auditor independence).

[3] See Rule 2-01(c)(1)(ii)(A) of Regulation S-X. These lending relationships also may include holding debt securities issued by an audit firm.

[4] “Investment company complex” generally includes: (1) an investment company and its investment adviser or sponsor; (2) any entity controlled by or controlling an investment adviser or sponsor, or any entity under common control with an investment adviser or sponsor if the entity: (a) is an investment adviser or sponsor, or (b) is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and (3) any unregistered investment company or entity relying on Section 3(c) of the 1940 Act that has an investment adviser or sponsor to a registered fund. See Rule 2-01(f)(14) of Regulation S-X.

[5] See PCAOB Rule 3520 (requiring audit firms and their associated persons to be independent of audit clients) and PCAOB Rule 3526 (requiring, among other things, that audit firms affirm their independence in writing and annually communicate with audit clients regarding their independence).

[6] The SEC staff notes that, for these purposes, the relevant institutions are those that control the record or beneficial owner of more than ten percent of the shares of the entity, and not entities controlled by or under common control with the owner. Therefore, the Loan Provision is not implicated simply because an affiliated sister company of an audit firm lender owns more than ten percent of a fund’s shares.

[7] “Mirror voting” occurs when an entity votes the shares held by it in the same proportion as the vote of all other shareholders.

[8] In these situations, the SEC staff notes that the audit firm cannot influence the audit of the entity. See letter at footnote 12.

[9] For example, if the fund solicits investor approval of a matter that could influence the objectivity of the audit firm, that fund could review available ownership records and contact applicable owners to inquire whether an institution in a lending relationship with the audit firm owns of record or beneficially more than ten percent of the shares of the fund. In so doing, funds might consider contacting those owners and seeking confirmation that they do not have discretionary voting authority to vote more than ten percent of those shares through negative consent letters.

[10] PCAOB Rule 3526(b)(1) requires the audit firm at least annually to describe, in writing, to the audit committee all relationships between the audit firm and the audit client, or persons in financial reporting oversight roles at the audit client, that may reasonably be thought to bear on independence. PCAOB Rule 3526(b)(2) requires the audit firm annually discuss with the audit committee the potential effects of the relationships on its independence.