

MEMO# 30258

September 23, 2016

Frequently Asked Questions About SEC Staff Letter on Auditor Independence and the "Loan Provision"

[30258]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 25-16
CHIEF COMPLIANCE OFFICER COMMITTEE No. 19-16
CHIEF RISK OFFICER COMMITTEE No. 27-16
CLOSED-END INVESTMENT COMPANY MEMBERS No. 15-16
COMPLIANCE MEMBERS No. 28-16
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 21-16
ETF ADVISORY COMMITTEE No. 20-16
INVESTMENT COMPANY DIRECTORS No. 26-16
SEC RULES MEMBERS No. 51-16
SMALL FUNDS MEMBERS No. 41-16 RE: FREQUENTLY ASKED QUESTIONS ABOUT SEC STAFF LETTER ON AUDITOR INDEPENDENCE AND THE "LOAN PROVISION"

The SEC's Division of Investment Management recently issued a letter^[1] that provides registered investment companies and other entities within an investment company complex with temporary no-action relief regarding audit services performed by public accounting firms that have certain relationships that might cause non-compliance with Rule 2-01(c)(1)(ii)(A).^[2] While the relief is addressed to certain Fidelity entities, the no-action letter also applies to other funds with the same facts. Funds may rely on the letter to satisfy a registration or reporting requirement, including financial reporting requirements.

ICI members have raised a number of questions about the letter to which we provide responses below.^[3]

1. Does the SEC staff no-action letter provide relief to a fund when an institution that has a lending relationship with the fund's auditor or covered persons of the auditor owns more than 10 percent of the shares of the fund and has discretionary voting authority over those shares?

It depends. This fund can rely on the letter until a matter, such as the election of board members or the appointment of an independent auditor, which could

influence the objectivity and impartiality of the independent auditor, is put before its shareholders for approval.

2. What steps related to an auditor's independence should a fund take if it will be seeking shareholder approval on a matter that could influence the objectivity and impartiality of the independent auditor?

When such a matter is being put before fund shareholders for approval, a fund must conduct a reasonable inquiry to determine the impact of the Loan Provision on the fund. In particular, the fund must identify greater than ten percent record and beneficial owners that serve as lenders to the fund's auditor and whether such an owner could exercise discretionary voting authority as of the matter's record date. The fund has flexibility to develop policies and procedures best suited to its organization in conducting this inquiry.[\[4\]](#)

Depending on the results of the reasonable inquiry, it may be appropriate for the fund or its auditor to consult with the SEC's Office of Chief Accountant. In certain circumstances, it may be necessary or appropriate for the fund to terminate the audit firm or ask the audit firm to resign in light of a Loan Provision violation.

3. To determine whether an entity owns more than 10 percent of a fund's shares or exercises discretionary voting authority, can a fund mail "negative consent" letters to certain identified owners (e.g., to entities that may have greater than 10 percent record or beneficial ownership of a fund and have a lending relationship with the audit firm) informing them that the fund will assume that they will not exercise discretionary voting authority over greater than 10 percent of the fund's shares unless the fund receives a written response indicating otherwise?

Yes. It is reasonable for funds to mail "negative consent" letters in an effort to confirm that record or beneficial ownership levels are not greater than 10 percent and/or ascertain whether an entity will exercise discretionary voting authority, as long as the letters are mailed with sufficient time for the entities to respond.

4. In that circumstance, must other funds in the complex also make that same type of reasonable inquiry?

No. The inquiry need only extend to the fund or funds that are seeking shareholder approval.

5. If a fund that conducts that reasonable inquiry finds that an institution that has a lending relationship with its auditor owns greater than 10 percent of the shares of the fund, can it take any steps so that it can continue to rely on the no-action letter?

Yes. The fund may rely on the letter if the greater than 10% owner has taken steps to limit its discretion to vote its shares (e.g., through "mirror voting" (also known as "shadow voting"), passing through the vote to an unaffiliated third

party, voting in accordance with the recommendations of an independent, third-party proxy voting advisory firm, holding shares in an irrevocable voting trust, or otherwise relinquishing its right to vote such shares) prior to or as of the record date of any matter that could influence the objectivity or impartiality of the independent auditor.[\[5\]](#)

6. Does the letter require that funds test fund ownership throughout the year or imply that audit firms will request testing throughout the year?

No. We understand that audit firms may seek to test greater than ten percent ownership for existing clients throughout the year. Funds, however, are not required to determine the impact of the Loan Provision (e.g., determine record or beneficial ownership and/or whether such an owner could exercise discretionary voting authority) unless a matter that could influence the objectivity and impartiality of the independent auditor is put before fund shareholders for approval.

7. In determining whether an intermediary that holds shares in street name has discretionary voting authority, is the staff viewing an intermediary voting on behalf of a client in reliance on NYSE Rule 452 as exercising discretionary voting authority?

Yes. Under NYSE Rule 452, NYSE members – which consist primarily of brokers and banks – are allowed to vote uninstructed proxies for their fund customers who beneficially own the stock in an uncontested, routine matter, such as the election of board members or reappointment of independent auditors. This constitutes discretionary voting authority. As discussed in question 5 above, if the intermediary sufficiently limits its discretion to vote those shares, the fund could continue to rely on the no-action letter.

8. If Cede & Co. holds of record all of a closed-end fund's shares and the fund determines no shareholder has filed a Form 3 or a Schedule 13D or 13G reporting beneficial ownership in excess of 10 percent, has the fund satisfied the reasonable inquiry standard to determine that the Loan Provision is not implicated?

No. While those forms should cover all instances in which an entity *beneficially* owns greater than 10 percent of a closed-end fund's shares, those forms do not cover instances when broker-dealers might be deemed *record owner* of more than 10 percent of a closed-end fund's shares and vote those shares with some discretion.

9. If less than a majority of fund board members are up for election (e.g., an election for a staggered board), is it necessary to conduct an inquiry into 10 percent ownership given that the less than majority of board members up for election could not themselves change the auditor?

Although the scenario is not addressed specifically in the no-action letter, such a fund may want to consider making a reasonable inquiry as of the record date

about the impact of the Loan Provision, because the SEC staff could construe this as a matter that could "influence the objectivity and impartiality of the independent auditor," which triggers the requirement under the letter to conduct a reasonable inquiry. Even though only certain board members are up for election, each board member may have the ability to influence the objectivity and impartiality of the independent auditor. Therefore, funds may want to consider making a reasonable inquiry about the impact of the Loan Provision whenever any board member is up for election.

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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>. 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.

[2] Rule 2-01(c)(1)(ii)(A) of Regulation S-X is referred to as the "Loan Provision" and provides in relevant part that an accountant is not independent when the accounting firm or any covered person in the firm (or any of his or her immediate family members) has any 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. Under the provision, the term "audit client" includes, not only the entity being audited, but any affiliates of the entity. When a fund is an audit client, any entity in the investment company complex is considered an affiliate. 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. The term "investment company complex" includes not only other funds but the investment adviser and certain affiliated entities. "Covered person" is defined to include any partners, principals, shareholders, and employees: (a) of the accounting firm's audit engagement team; (b) that supervise or have direct management responsibility for the audit, evaluate the performance or recommend compensation of the audit engagement partner, or provide quality control or oversight of the audit; (c) any other partner, principal, shareholder or managerial employee of the accounting firm that has provided ten or more hours of non-audit services to the audit client for the fiscal year in which those services are provided or that expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; or (d) any other partner, principal, or shareholder from an office of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

[3] We have had a number of calls focused on the letter since it was issued in June with ICI members and staff of the Division of Investment Management. While the SEC staff reviewed this memorandum, as a matter of policy, their review does not indicate agreement with, or approval of, its contents. Nothing in this memorandum is intended to serve as legal advice. Each fund, fund board, and investment adviser should seek the advice of counsel for issues related to its individual circumstances.

[4] See SEC staff no-action letter at note 11.

[5] See SEC staff no-action letter at notes 6 and 14.

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