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SEC Proposes Amendments to Auditor Independence Loan Rule

[31198]

May 7, 2018 TO: ICI Members
Investment Company Directors SUBJECTS: Audit and Attest
Audit Committees
Compliance
Fund Accounting & Financial Reporting RE: SEC Proposes Amendments to Auditor Independence Loan Rule

On May 2, the Securities and Exchange Commission issued for public comment proposed amendments to its auditor independence rule intended to address loans and debtor-creditor relationships.[1] The Commission has become aware that, in certain circumstances, the current rule may not be functioning as intended and that there are certain fact patterns where the auditor's objectivity and impartiality are not impaired despite a failure to comply with the rule. The proposed amendments would refocus the analysis of the auditor's debtor-creditor relationships with shareholders of audit clients by: i) eliminating violations solely due to record ownership; ii) replacing the existing more than 10 percent bright-line ownership test with the concept of "significant influence"; iii) adding a "known through reasonable inquiry" standard when identifying beneficial owners of the audit client's equity securities; and iv) narrowing the definition of "audit client" to exclude funds that would be considered affiliates of the audit client. Comments on the proposal are due to the SEC 60 days following publication in the *Federal Register*.[2]

I. Background

Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Rule") generally provides that an accountant 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. The term "audit client" includes any affiliate of the entity whose financial statements are being audited, and "affiliate" for this purpose includes entities that control, are controlled by, or are under common control with the audit client.[3] As a result, an audit firm generally is not independent if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of the equity securities of either (a) the firm's audit client, or (b) any entity that controls, is controlled by, or is under common control with the audit client.

During 2016, certain funds and investment advisors disclosed compliance concerns relating to the Loan Rule. These disclosures indicated, for example, that the 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. Subsequently the SEC staff issued a no-action letter providing relief from the Loan Rule's independence requirements under certain specified circumstances.[4] The no-action letter, originally set to expire 18 months after issuance, was extended until the effective date of any amendments to the Loan Rule intended to address the concerns expressed in the no-action letter.[5]

II. Proposed Amendments

The proposed amendments are designed to better focus the Loan Rule on those relationships that truly could threaten the auditor's ability to exercise objective and impartial judgment. The proposed amendments would apply broadly to entities beyond the investment management industry, including operating companies and broker-dealers.

Eliminate Record Ownership Violations

The proposed amendments would eliminate record ownership violations from the Loan Rule so that it would apply only to beneficial owners of the audit client's equity securities. The Proposing Release notes that record owners often do not benefit from the performance of the securities for which they are record owners, and that they have little incentive to affect the auditor's report. Focusing the analysis on beneficial owners would more effectively identify shareholders that have stronger incentives to influence the auditor's report.

Replace More Than 10 Percent with Significant Influence

The proposed amendments would replace the current more than 10 percent of the audit client's equity securities test with a "significant influence" test. This test would focus on a lender's ability to influence the policies and management of an audit client, based on the totality of the facts and circumstances. An audit firm, together with its audit client, would be required to assess whether a lender (that is also a beneficial owner of audit client's equity securities) has the ability to exert significant influence over the audit client's operating and financial policies.

Although not specifically defined, the term "significant influence" appears in other parts of the SEC's auditor independence rule, and the Proposing Release indicates that the SEC will look to guidance in US GAAP.[6] That guidance includes a rebuttable presumption that a lender beneficially owning 20 percent or more of an audit client's voting securities is presumed to have the ability to exercise significant influence over the audit client, absent evidence to the contrary.[7] The GAAP guidance also indicates 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.

The Proposing Release indicates that, in the fund context, operating and financial policies relevant to the significant influence test would include the fund's investment policies and day-to-day portfolio management processes, including those governing the selection, purchase and sale, and valuation of investments, and the distribution of income and capital gains (collectively "portfolio management processes"). An audit firm could analyze whether significant influence over the fund's portfolio management processes exists based on an initial evaluation of the fund's governing documents, its contractual arrangements, and

other factors. In circumstances where the terms of the fund's advisory agreement grant the adviser significant discretion with respect to portfolio management processes, significant influence generally would not exist. Voting rights relating to approval of the fund's advisory contract or changes to fundamental policies on a *pro rata* basis should not lead to a determination that a shareholder has significant influence.

In circumstances where significant influence could exist, the audit firm would evaluate whether any beneficial owner of shares of a fund audit client has the ability to exercise significant influence over the fund and has a debtor-creditor relationship with the audit firm, its covered persons and their immediate family members. If the audit firm determines that significant influence does not exist at the time of its initial evaluation, the Proposing Release indicates that the auditor should monitor the Loan Rule on an ongoing basis by, for example, reevaluating its determination when there is a material change in the fund's governing documents, publicly available information about beneficial owners, or other information that may implicate the ability of a beneficial owner to exert significant influence.

Reasonable Inquiry Standard

The proposed amendments would add a "known through reasonable inquiry" standard to address concerns about accessibility to records or other information about beneficial ownership. Under this standard, an audit firm, in coordination with its audit client, would be required to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry. According to the Proposing Release, this standard generally is consistent with regulations implementing the Investment Company Act, the Securities Act, and the Exchange Act[8] and should therefore be familiar.

Excluding Other Funds That Would Be Considered Affiliates of the Audit Client

The proposed amendments would, for the purposes of the Loan Rule, narrow the definition of "audit client" to exclude any other fund that would be considered an affiliate of the audit client.[9] The current definition of "audit client" includes all "affiliates of the audit client," which broadly encompasses each entity in an investment company complex of which the audit client is a part. This could cause non-compliance with the Loan Rule as to a broad range of entities, including entities the auditor does not audit. The proposed amendments would address these situations.

III. Alternatives Considered

The Commission seeks comment on all aspects of the proposed changes, as well as certain changes it considered but did not propose, including:

- Materiality – Should the Loan Rule include a materiality qualifier? For example, the auditor's independence would be impaired where the lender to the audit firm has beneficial ownership in the audit client's equity securities and that investment is material to the lender or to the audit client (and the lender has the ability to exercise significant influence over the audit client)? Which qualitative and quantitative factors should be considered in assessing materiality? Would a materiality assessment add unnecessary complexity?

- Covered Persons – Should the definition of "covered persons" be changed? Should the types of loans excluded from the Loan Rule be changed?

- Measuring Compliance – The SEC's auditor independence rule provides that an auditor is not independent if at any point during the audit and professional engagement period it has an independence impairing relationship. Should the Commission make changes to the frequency with which, the dates as of which, or circumstances under which the auditor must assess compliance? Should compliance be assessed at specific dates?

- Secondary Market Purchases of Debt – The Loan Rule encompasses lending arrangements that may change based on secondary market purchases of syndicated or other debt. Should such secondary market relationships be taken into account or excluded from the Loan Rule?

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endnotes

[1] *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships,* Release No. 33-10491 (May 2, 2018) ("Proposing Release"), *available at* https://www.sec.gov/rules/proposed/2018/33-10491.pdf.

[2] To date, the Government Publishing Office has not published the proposal in the *Federal Register*.

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

[4] *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.

[5] *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.

[6] Financial Accounting Standards Board ASC Topic 323, *Investments–Equity Method and Joint Ventures.* That guidance appears at 323-10-15-6 through 323-10-15-11.

[7] ASC 323 also lists indicators that would suggest a shareholder that owns 20 percent or more of the audit client's voting securities may be unable to exercise significant influence, including, for example, a standstill agreement under which the shareholder surrenders significant rights as a shareholder.

[8] *See, e.g.,* Rule 3b-4 under the Exchange Act; Rule 144(g) under the Securities Act; Rule 502(d) under the Securities Act; and Item 18 of Form N-1A requiring the fund to disclose the name, address, and percentage of ownership of each person who owns of record or is known by the fund to own beneficially five percent or more of the fund's outstanding equity securities.

[9] The proposal also would indicate that, for purposes of the Loan Rule, the term "fund" means an investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act.
