

COMMENT LETTER

March 16, 2020

Letter on Proposed Amendments to SEC Auditor Independence Rule (pdf)

March 16, 2020 Ms. Vanessa Countryman Secretary Securities and Exchange Commission
100 F Street, NE Washington, DC 20549 Re: Amendments to Rule 2-01, Qualification of Accountants (File Number S7-26-19) Dear Ms. Countryman: The Investment Company Institute¹ and the Independent Directors Council² applaud the Securities and Exchange Commission's proposed amendments to its auditor independence rule.³ The SEC's auditor independence rule is intended to ensure that auditors are independent, both in fact and in appearance, so that investors and others relying on financial reporting to make investment decisions have confidence in audited financial statements. Ensuring the objectivity and impartiality of auditors to investment companies is paramount. Investment companies—both as investors and as issuers—strongly support the goals of the Commission's auditor independence rule. Fund board audit committees, which play a critical role in overseeing the audit of the fund's financial statements and protecting the interests of shareholders, also have a compelling interest in the independence of auditors. The Proposing Release indicates that the Commission seeks to maintain the relevance and effectiveness of its auditor independence requirements in light of current market conditions. The Proposal is intended to more effectively focus the independence analysis on those relationships or services that are most likely to threaten the auditor's independence and is based on the

¹ The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$ 25.2 trillion in the United States, serving more than 100 million US shareholders, and US\$7.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

² The Independent Directors Council (IDC) serves the US-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

³ See Amendments to Rule 2-01, Qualification of Accountants, SEC Release No. IC-33737 (December 30, 2019) ("Proposal" or "Proposing Release") available at <https://www.sec.gov/rules/proposed/2019/33-10738.pdf>. Ms. Vanessa Countryman March 16, 2020 Page 2 of 9 Commission's experience administering the rule since its initial adoption nearly two decades ago. The proposed changes address scenarios that are non-

substantive and technical violations of the rule where the Commission has concluded, through its experience over the years, that the auditor's objectivity and impartiality are not impaired. Monitoring for these "false positives" has been time consuming and costly, without a corresponding benefit for fund shareholders. Provided that the safeguards ensuring auditor independence remain in place, modernizing the rules to address non-substantive and technical violations will save audit committees, management, auditors, and Commission staff time and resources and enable them to more effectively focus on accounting and auditing matters of importance to the integrity and reliability of a fund's financial statements. This is especially critical to fund board audit committees, as their primary responsibility is to oversee the fund's financial reporting process and the audit of the financial statements for the benefit of shareholders. Accordingly, we strongly support the Proposal and are pleased to provide comments on specific aspects of the proposed changes to the rule as described below.

I. Amendments to Definitions A. Affiliate of the Audit Client Currently, the definition of audit client broadly encompasses affiliated entities, including sister entities, regardless of whether the sister entities are material to the controlling entity.⁴ The Proposal would amend the "affiliate of the audit client" (AAC) definition to include a materiality qualifier with respect to operating companies under common control.⁵ When applying the AAC definition to operating companies, including portfolio companies, the Proposal would focus the auditor independence analysis on entities under common control with the audit client (sister entities) that are material to the controlling entity. Specifically, proposed 2-01(f)(4)(i)(B) would provide that an AAC includes an entity which is under common control with the audit client, unless the entity is not material to the controlling entity. The Proposal indicates that, based on the staff's experience administering the rule, audit firms having relationships with or providing services to sister entities that are not material to the 4 Under Rule 2-01, an "audit client" is defined as the entity whose financial statements or other information is being audited, reviewed or attested and any affiliates of that entity. The definition of "affiliate of the audit client" includes an entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client and each entity in the investment company complex when the audit client is an entity that is part of an investment company complex. "Investment company complex" (ICC) is defined to include, in part, any entity controlled by or controlling an investment adviser or sponsor or any entity under common control with the investment adviser or sponsor if the entity: 1) is an investment adviser or sponsor; or 2) is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor. 5 In the Proposal, the SEC indicates "operating company" refers to entities that are not investment companies, investment advisers or sponsors, and "portfolio company" refers to an operating company that has among its investors, investment companies or unregistered funds in private equity structures. Ms. Vanessa Countryman March 16, 2020 Page 3 of 9 controlling entity typically do not present issues with the respect to the audit firm's objectivity and impartiality. We agree, and we support the materiality qualifier in proposed 2-01(f)(4)(i)(B). The Proposal also would amend the AAC definition to make clear that when the entity under audit is a portfolio company, the identification of sister entities must occur under the proposed AAC definition and that when the entity under audit is an investment company or an investment adviser, the auditor should look solely to the ICC definition to identify affiliates.⁶ We support this change and believe it will provide clarity to auditors and their audit clients when identifying affiliates. The Proposal does not indicate how to determine affiliates if the investment adviser is the entity under audit and also is an issuer and the parent entity. We encourage the Commission to clarify how the independence analysis would be applied to this scenario in its adopting release. We also encourage the Commission to consider including additional

scenarios illustrating the interaction of the amended definitions of AAC and ICC in any adopting release, or that the Commission staff consider issuing guidance in the form of FAQs.

B. Investment Company Complex

i. Common Control with any Investment Company or Investment Adviser

Under the existing regulatory framework, an auditor to an investment company cannot provide any prohibited services to, or have any prohibited relationships with, an investment adviser that is under common control with the investment adviser to the investment company (sister investment adviser) or any investment companies advised by a sister investment adviser.⁷ These prohibitions are in place regardless of whether the sister investment adviser and the investment companies it advises are material to the controlling entity. The Proposal appropriately introduces a materiality qualifier.⁸ The concept of materiality is especially critical for investment companies and their investment advisers, which are often part of far-flung global organizations with different investment advisers controlled by a common parent company. The auditor independence analysis for the expansive and constantly changing set of entities is complex, costly, time consuming, and may trigger a range of auditor independence violations that do not impair an auditor's objectivity and impartiality. A 6

Proposed rule 2-01(f)(4)(ii). 7 The sister investment adviser is included in the definition of the ICC and, therefore, is an AAC. Rule 2- 01(f)(14)(i)(B). 8 The Proposal would align the common control prong of the proposed ICC definition with the common control prong for operating companies under the proposed AAC definition. Specifically, proposed paragraph (f)(14)(i)(D)(1) includes only those sister investment advisers and sister investment companies that are material to the controlling entity. If the sister investment adviser and sister investment companies are not material to the controlling entity, they would be excluded from the ICC. The general independence standard under Rule 2-01(b) would still apply. Ms. Vanessa Countryman March 16, 2020 Page 4 of 9 materiality qualifier will reduce the likelihood of these non-substantive violations and may broaden the pool of prospective accounting firms an investment company can engage as auditor. For these reasons, we support the introduction of a materiality qualifier. We note that it will be important for auditors and their investment company audit clients to have access to financial reporting information relating to the parent company, the different investment advisers under common control, and the investment companies they advise, to make the contemplated materiality determinations.

ii. Materiality Assessment

The Proposal is silent as to the assessment of materiality in the investment company context. The investment companies in a given complex typically have fiscal year ends spread throughout the calendar year and fund net assets can change significantly due to changes in the value of assets or shareholder flows, so clarity regarding the required timing and frequency of monitoring materiality throughout an audit and professional engagement period is important. We encourage the Commission to consider clarifying that, if the sister investment adviser or a fund advised by the sister investment adviser is immaterial to the controlling entity at the time of the initial assessment, the audit client fund and its auditor could satisfy their obligations to monitor materiality on an ongoing basis by reevaluating materiality in response to significant transactions, SEC filings, or other information that becomes known to the auditor, or the audit client fund, through reasonable inquiry. This approach would be consistent with the guidance the Commission provided in the "loan provision" adopting release.⁹

iii. Investment Companies that Share an Investment Adviser

The proposed amendments would not change the independence analysis for sister investment companies with a shared investment adviser.¹⁰ The auditor would continue to be required to monitor, as part of its independence analysis, investment companies that share the same investment adviser as the investment company under audit. The Proposing Release requests comment on whether the Commission should include a materiality qualifier so that sister investment companies sharing an investment adviser may be excluded from the ICC.

Investment companies sharing an investment adviser often have the same board of directors, the same audit committee, the same system of internal control over financial reporting, and may invest in the same securities. For these reasons, we do not support including a materiality 9 See Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships, Release No. IC-33511 (June 18, 2019) (“Loan Provision or Loan Provision Adopting Release”). 10 Proposed Rule 2-01(f)(14)(i)(F). Ms. Vanessa Countryman March 16, 2020 Page 5 of 9 qualifier in this context and, therefore, do not recommend adding such a qualifier in proposed paragraph (f)(14)(i)(F).¹¹ iv. Significant Influence within the ICC Definition As described above, the Proposal clarifies that when the entity under audit is an investment company or an investment adviser or sponsor, the auditor should look to the proposed ICC definition to determine which entities would be considered affiliates of the audit client. The Proposal includes in the proposed ICC definition a significant influence prong,¹² which would align it with the current significant influence analysis applicable to operating companies. The Proposing Release indicates that the Loan Provision Adopting Release clarified what constitutes significant influence in an investment company context,¹³ and that analysis would apply to the significant influence analysis required under the proposed ICC definition.¹⁴ We recommend that any adopting release reiterate this statement so that investment company auditors and their audit clients understand the nature of the analysis to be performed. v. Entities Providing Administrative, Custody, Underwriting or Transfer Agency Services Under the current ICC definition, any entity under common control with the investment adviser that is engaged in the business of providing administrative, custody, underwriting, or transfer agency services to any investment company or investment adviser is included in the ICC.¹⁵ Under the Proposal, entities under common control with the investment adviser engaged in the business of providing administrative, custody, underwriting, or transfer agency services are 11 We note, however, that the recent amendments to the Loan Provision exclude other funds that would otherwise be considered an affiliate of the audit client from the definition of audit client, but only for purposes of debtor/creditor relationships. 12 Proposed Rule 2-01(f)(14)(E). As a result, an entity with significant influence over a fund or its investment adviser would be included in the ICC, unless the fund or its adviser is not material to the entity with significant influence. Also, any entity over which the fund or its adviser have significant influence would be included in the ICC, unless the entity is not material to the fund or adviser. 13 The Loan Provision Adopting Release indicates that the operating and financial policies relevant to the significant influence test 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”). The Loan Provision Adopting Release goes on to state that an audit firm’s initial analysis under the Loan Provision could analyze whether a shareholder-creditor has significant influence over a fund’s portfolio management process based on its governance structure and contractual arrangements, and that if the investment advisory agreement provides the investment adviser with significant discretion concerning the fund’s portfolio management processes, and no shareholder-creditor has the power to influence those portfolio management processes, then significant influence is unlikely to exist. 14 See footnote 28 at page 23 of the Proposing Release. 15 Rule 2-01(f)(14)(i)(B)(2). Ms. Vanessa Countryman March 16, 2020 Page 6 of 9 included in the ICC only to the extent they provide services to an investment company or investment adviser within the ICC.¹⁶ The proposed change recognizes that where the investment company auditor provides services to, or has relationships with, these service companies, those relationships and services do not threaten the auditor’s objectivity and impartiality so long as the service companies do not provide services to the investment companies and investment advisers in the ICC. II. Loans

or Debtor-Creditor Relationships A. Student Loans Under the current rule, an accountant is not independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loans to or from an audit client, or certain entities or persons related to the audit client. Certain loans from a financial institution under its normal lending procedures, terms and requirements are excepted from the prohibition. The Proposal adds to the list of excepted loans student loans for a covered person's educational expenses provided the loan was obtained by the individual prior to becoming a covered person in the firm. The proposed amendment would not include student loans obtained for a covered person's immediate family members. The Proposing Release explains that the Commission is concerned that the amount of student loan borrowings obtained for multiple immediate family members could be significant and could affect the covered person's objectivity and impartiality. We support the addition of student loans to the covered person to the list of excepted loans provided the loan was obtained prior to becoming a covered person. The proposed exception for student loans is similar to the existing exception for mortgage loans obtained prior to the person becoming a covered person. We believe these "grandfathered" loans do not affect the covered person's objectivity and impartiality and would not cause a reasonable investor to conclude that the auditor is incapable of exercising independent judgment. For the same reasons, we believe a student loan to the covered person's immediate family members would not impair the covered person's objectivity and impartiality, so long as the loan(s) to the immediate family member(s) was obtained prior to the person becoming a covered person. We, therefore, recommend that the Commission include in the list of excepted loans student loans to immediate family members of the covered person.

B. Credit Cards The current rule prohibits any outstanding credit card balance owed to a lender that is an audit client that is not reduced to \$10,000 or less on a current basis. The Proposal would substitute "consumer loan" for "credit card" so that it covers other types of consumer financing borrowers routinely obtain for personal consumption, including installment loans, cell phone loans, and home improvement loans.

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This change is consistent with our recommendations on the Loan Provision proposing release¹⁷ and we continue to support it. The proposed change will recognize traditional personal consumption loans without compromising the covered person's objectivity and impartiality.

III. Business Relationships Rule Currently, Rule 2-01(c)(3) prohibits, at any point during the audit and professional engagement period, the accounting firm or any covered person from having any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The term "substantial stockholders" is not defined. The Proposal would omit "substantial stockholders" from the rule and substitute "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client." We support this change. As noted above, the concept of significant influence is clear in its application to the investment company context. Moreover, the concept of significant influence more appropriately focuses attention on circumstances in which an auditor's objectivity and impartiality may be compromised. The Proposing Release indicates that the application of significant influence to investment companies in the context of the business relationships rule should follow the guidance provided in the Loan Provision Adopting Release.¹⁸ We again recommend that any adopting release reiterate this statement so that investment company auditors and their audit clients understand the nature of the analysis to be performed.

IV. Inadvertent Violations for Mergers and Acquisitions The Proposal adds a transition framework to the rule for inadvertent auditor independence violations arising from a merger or acquisition transaction.¹⁹ Under the proposed framework, the accounting firm's independence will not

be impaired because an audit client engages in a merger or acquisition that gives rise to a prohibited relationship or service, provided that the accounting firm satisfies certain specified conditions, including correcting the violation as promptly as possible under the relevant circumstances.²⁰ ¹⁷ See Letter from Martin A. Burns and Amy B.R. Lancellotta to Brent J. Fields (July 9, 2018) available at <https://www.sec.gov/comments/s7-10-18/s71018-4018268-167326.pdf>. ¹⁸ See footnote 42 at page 35 of the Proposing Release. ¹⁹ Proposed Rule 2-01(e). ²⁰ We note that the proposed transition framework for merger and acquisition transactions is similar in concept to existing paragraph (d) of the rule, which provides that the audit firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided the covered person did not know of the circumstances giving rise to the violation, the violation was corrected as promptly as possible after the Ms. Vanessa Countryman March 16, 2020 Page 8 of 9 We agree that auditor independence issues arising out of a merger or acquisition transaction can have adverse effects on the audit client, such as the termination of an ongoing audit or the termination of a non-audit service in progress in a manner that is costly to the audit client. We believe the proposed framework will allow the auditor and the audit client to transition out of the prohibited services and relationships in an orderly manner. We also believe that the proposed conditions that the auditor must satisfy in order to rely on the framework preserve investor protections. For these reasons, we support the proposed transition framework for merger and acquisition transactions. We also urge the Commission to clarify that the framework applies to situations where the service or relationship is identified on or after the transaction closing date. V. Continuing Considerations We encourage the Commission and its staff to continue to consider the effectiveness of its auditor independence rule as market and industry conditions evolve. It is imperative for the rule to continue ensuring auditor independence, both in fact and appearance, and, at the same time, minimizing the likelihood of false positives that divert audit committee and management resources from substantive accounting and auditing matters. Shareholder interests must be paramount in any assessment of the rule's effectiveness. As we stated above, shareholders are not well served when audit committee and management resources are spent addressing non- substantive technical violations that do not impair the auditor's objectivity and impartiality. One aspect of the rule that may be ripe for reassessment is the mandate requiring independence from any partner, principal, or shareholder from an office of the accounting firm in which the lead engagement partner primarily practices ("Type IV Covered Persons").²¹ This is intended to ensure that the covered person has no incentive to influence the audit, and that the audit client cannot influence the covered person. For example, the concept of an "office"²² has become less relevant over time due to changes in work practices, including "hoteling" and "tele-commuting."²³ Also, partners or principals in the office who are not a part of the assurance practice (e.g., tax or management advisory services) would not be able to influence an audit. Finally, the mandate may be too broad in instances where the lead engagement partner primarily practices in an office different than the local office where audit staff is located. For these reasons, we encourage the Commission to continue its consideration as to whether the auditor independence rule is effectively ensuring the independence of auditors while protecting the interests of fund shareholders. covered person became aware of it, and the accounting firm maintains a quality control system that provides reasonable assurance that the firm and its employees do not lack independence. ²¹ Rule 2-01(f)(11)(iv). ²² Office means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines. See Rule 2-01(f)(15). ²³ We note that the AICPA's Professional Ethics Executive Committee is currently considering whether to provide guidance on the definition of office. See AICPA Strategy and Work Plan Consultation Paper (November 15, 2019). Ms. Vanessa Countryman March 16, 2020 Page 9 of 9 * * * * *

We appreciate the opportunity to comment on the proposed amendments. If you have any questions regarding our comment letter or would like additional information, please feel free to contact Lisa Hamman at (202) 371-5405 or lch@ici.org, or Greg Smith at (202) 326-5851 or smith@ici.org. Sincerely, Martin A. Burns Thomas T. Kim Chief Industry Operations Officer Managing Director Investment Company Institute Independent Directors Council cc: The Honorable Jay Clayton The Honorable Hester M. Peirce The Honorable Elad L. Roisman The Honorable Allison Herren Lee Sagar Teotia, Chief Accountant Office of the Chief Accountant Dalia O. Blass, Director Alison Staloch, Chief Accountant Division of Investment Management

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