July 5, 2016

SEC Staff Addresses Funds' Auditor Independence Problem

On June 20, 2016, the SEC's Division of Investment Management provided a temporary no-action letter (the "Letter") to a fund group (the "Fund Group") applicable to registered investment companies (each, a "Fund") and other entities (each, an "Entity") within the Fund Group whose financial statements are audited by a public accounting firm that is not "independent" from the Funds because of non-compliance with Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Rule"). The Letter states that the SEC staff would not recommend enforcement action against any Fund or Entity that continues to rely on financial statement certifications from an accounting firm that is not in compliance with the Loan Rule in circumstances described in the Letter. The Letter's relief is subject to certain conditions (described below) and will expire in December 2017.

Background. A registered investment company must distribute an annual report to its shareholders that is certified by a public accounting firm (an "audit firm") that is "independent," and that annual report is incorporated into the investment company's registration statement filed with the SEC.[1]

Rule 2-01 of Regulation S-X sets forth the conditions for an audit firm to be independent from its audit clients. Rule 2-01(c), which includes the Loan Rule, sets forth various relationships that the SEC deems to be *per se* inconsistent with an audit firm's independence. The Loan Rule provides that an audit firm is not independent when the audit firm has a loan from "record or beneficial owners of more than ten percent of the audit client's equity securities." As defined, "audit client" includes any affiliate of the audit client and, when the audit client is an entity within an "investment company complex,"[2] it also includes every entity within the investment company complex. Therefore, an audit firm's lack of independence with respect to *one entity* within an investment company complex due to a Loan Rule violation potentially renders the audit firm non-independent with respect to *every entity* within the investment company complex.

In May and June 2016, in various SEC filings, funds from at least eight fund families publicly disclosed that their audit firm had informed their audit committees that the audit firm had a loan from a lender that was a record or beneficial owner of more than ten percent of the shares of one or more funds within the fund family, in apparent violation of the Loan Rule. The disclosures cautioned that there could be potential adverse consequences for the funds if the SEC were to determine that the audit firm was not independent. The legal uncertainty faced by the disclosing funds and other funds that had not yet disclosed the problem to the SEC was reported by the industry press and *The Wall Street Journal*.

[1] In addition, certain private funds will engage independent public accounting firms to enable their investment advisers to comply with Rule 206(4)-2 under the Investment Advisers Act (the "custody rule"), which provides an exemption for certain advisers to private funds if, among other things, the private fund is audited annually by an independent audit firm, and the private fund's audited financial statements are distributed to its investors.

[2] "Investment company complex" includes (1) an investment company and its adviser; (2) any entity controlled by or controlling the adviser; (3) any entity that is under common control with the investment company's adviser that is an adviser or provider of administrative, custodian, underwriting, or transfer agent services to any investment company; and (4) any investment company or entity that would be an investment company but for the exclusions provided by Section 3(c) of the 1940 Act that has an adviser within (1), (2) or (3).

The Letter. In its request for no-action relief, the Fund Group stated that the Funds may face one or more of the following lending arrangements involving their audit firm and implicating the Loan Rule (the "Lending Relationships"):[3]

- An institution that is a lender to the audit firm holds of record, for the benefit of its clients or customers (*e.g.*, as an omnibus account holder or custodian), more than ten percent of the shares of a Fund or Entity.
- An insurance company that is a lender to the 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.
- An institution that is a lender to the audit firm acts as an authorized participant or market maker to a Fund that is an ETF and holds of record or beneficially more than ten percent of the shares of the ETF.

The SEC staff did not disagree with the Fund Group's stated concern that, under the Loan Rule, the Fund or Entity's audit firm with a Lending Relationship could be deemed non-independent with respect to that Fund or Entity and, further, that this concern would exist regardless of whether the lending institution was able to influence the audit firm, or any Fund or Entity. However, the Fund Group argued, the concerns underlying the Loan Rule are generally not implicated by the Lending Relationships if the record or beneficial owner of shares of a Fund or Entity is unable to exercise undue influence over the Fund or Entity, and the audit firm's impartiality is not impaired.

The SEC staff noted the following representations by the Fund Group:

1. The audit firm had represented to the Fund Group that, notwithstanding the audit firm's noncompliance with the Loan Rule, following an evaluation of the impact of the audit firm's Lending Relationship on its independence, the audit firm had maintained its impartiality with respect to the planning for and execution of the Funds' audits.
2. The audit firm had emphasized to the Fund Group that, under the Loan Rule, the lending institution was unable to affect the audit firm's impartiality or to influence the Fund of which the lending institution was a shareholder or the Fund's investment adviser.
3. Those responsible for the oversight of the Funds[4] had not reached a different conclusion with respect to the audit firm's impartiality.
4. With respect to each of the Lending Relationships, if one or more matters relating to (a) the election of trustees or directors, (b) the appointment of an independent audit firm, or (c) other matters that similarly could influence the objectivity and impartiality of the audit firm were put before shareholders of a Fund or Entity for a vote, the Fund Group would make "reasonable inquiry" as of the record date for the vote concerning the impact of the Loan Rule.

[3] The staff also noted that, "for purposes of the Lending Relationships, the relevant institutions are those that control the record or beneficial owner of more than ten percent of the shares of a [Fund or Entity] (*i.e.*, entities that are under common control with or controlled by the record or beneficial owner are not as such implicated by the Loan [Rule])." The meaning of the parenthetical may give rise to interpretive questions.

[4] It is unclear whether "those responsible for oversight" was intended to encompass each such fund's entire board (including a majority of its non-interested members), audit committee or adviser (or a combination or a subset thereof). As discussed below, a condition of the Letter is that prior to engaging an audit firm, and annually during the audit engagement, the audit committee ("or relevant management committee, in the case of a [Fund Group entity] that is not a [registered fund]") will continue to receive from the audit firm communications in which the audit firm represents that it complied with PCAOB Rules 3526(b)(1) and (2) or substantially equivalent communications, as applicable. This suggests that, for a registered investment company, "those responsible for oversight" should, at a minimum, include the audit committee.

i. Reasonable inquiry would be based on policies and procedures regarding, for example, the review of available ownership records and contacting ten-plus percent record owners to inquire whether a lending institution in a Lending Relationship owns of record or beneficially more than ten percent of the shares of the Fund or Entity.

ii. If the reasonable inquiry reveals that a lending institution in a Lending Relationship can exercise discretionary voting authority with respect to at least ten percent of the Fund or Entity's shares, the Fund or Entity would not rely on the Letter and, instead, "take other appropriate action, consistent with its obligations under the federal securities laws."

iii. "Other appropriate action" is undefined. However, in a footnote, the Letter states that the relief is available if a lending institution agrees to echo (or mirror) vote the Fund or Entity's shares, to pass through the vote to an unaffiliated third-party entity or to relinquish its right to vote the shares. Alternatively, in another footnote, the Letter states that the relief is available if the Fund or Entity relies on a different audit firm.

Based on these representations, the SEC staff stated that it would not object to any Fund or Entity using financial statements to comply with the federal securities laws that require an audit opinion, when such opinion is made by an audit firm that has identified a failure to comply with the Loan Rule, where the failure to comply with the Loan Rule is limited to the Lending Relationships and where the audit firm's judgment remains objective and impartial. The following conditions apply:

1. The audit firm has complied with Public Company Accounting Oversight Board ("PCAOB") Rules 3526(b)(1) and (2)[5] or, with respect to an entity to which Rule 3526 does not apply, has provided substantially equivalent communications;

2. The audit firm's non-compliance is with respect to one or more of the three Lending Relationships; and

3. Notwithstanding such non-compliance, the audit firm has concluded that it is objective and impartial with respect to the issues within its engagement.

Finally, the Letter stated that the staff's no-action relief will expire in December 2017, unless the SEC staff decides to renew it.

* * *

For now, the Letter resolves the legal uncertainty faced by the Fund Group and other similarly situated fund families. Therefore, it provides welcome relief.

As noted above, the Letter requires reasonable inquiry if one or more matters that could influence the objectivity and impartiality of the audit firm (*e.g.*, the election of trustees or directors or the appointment of an independent auditor) are put before shareholders. Reasonable inquiry for closed-end funds may be harder than reasonable inquiry for open-end funds because closed-end fund shares are generally (at least for exchange-listed closed-end funds) held by Cede & Co., as nominee for the Depository Trust Company ("DTC"). In connection with their annual proxy statements, closed-end funds often rely on Regulation 13D under the Exchange Act and related filings of Schedules 13D and 13G to identify significant owners with voting or investment discretion. However, the Letter does not

[5] Rule 3526(b)(1) requires an audit firm to communicate annually in writing with each audit client's audit committee regarding the audit firm's independence, including all relationships that, as of the date of the communication, may reasonably be thought to bear on independence. Rule 3526(b)(2) requires an audit firm to discuss annually with each client's audit committee the potential effects of the relationships described in the communication required by (b)(1) on the independence of the audit firm.

address whether monitoring such filings constitutes reasonable inquiry. The alternative would appear to require closed-end funds to acquire, at substantial cost to the fund, a list of beneficial owners from DTC.

The Letter does not expressly state whether an audit firm's disclosure of the identities of its lenders should be part of a reasonable inquiry. There could be substantial efficiencies from employing a top-down approach to identify lenders to the audit firm that are also fund shareholders (relative to identifying and asking each ten-percent record shareholder whether it is a lender to the audit firm).

Finally, it is unclear whether the December 2017 sunset on the relief provided by the Letter suggests that the SEC may amend the Loan Rule as a permanent solution to the problems that led to the Letter, or that the staff assumes that this 18-month period will give accounting firms and their lenders enough time to address the issues without requiring any changes to the Loan Rule.

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.