ROPES & GRAY

ALERT

Asset Management

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SEC Proposes Rule Change to Address Funds' Auditor Independence Problem

In a May 3, 2018 release (the "Release"), the SEC proposed amendments to the "Loan Rule" (as defined below), part of the SEC's auditor independence rule, Rule 2-01 of Regulation S-X. If adopted as proposed, the amendments should virtually eliminate the problems that led to the SEC staff's 2016 no-action letter regarding the application of the Loan Rule to an investment company complex.[1]

The Release states that the SEC is aware that the Loan Rule is not currently working as intended and can have "broader disruptive effects, particularly for funds." The Release acknowledges that there are certain fact patterns in which an auditor's independence is not impaired despite a failure to comply with the current requirements of the Loan Rule. To remedy the situation, the SEC is proposing amendments so that the Loan Rule will better focus on debtor-creditor relationships that may impair an audit firm's impartiality. Specifically, the proposed amendments:

- Limit the analysis under the Loan Rule to beneficial ownership without considering record ownership;
- Replace the Loan Rule's ten percent "bright-line" shareholder ownership test with a "significant influence" test;
- Apply a "known through reasonable inquiry" standard to identification of beneficial owners of an audit client's equity securities; and
- Amend, for purposes of the Loan Rule, the definition of "audit client" for a fund under audit (whether a registered fund or a private fund) to exclude funds that otherwise would be considered affiliates of the audit client.

A copy of the Loan Rule, marked to show the proposed amendments, is available here.

I. Background

Rule 2-01 of Regulation S-X sets forth conditions for an audit firm to be independent from an audit client. Rule 2-01(c) sets forth a non-exhaustive list of relationships that the SEC deems to be *per se* inconsistent with an audit firm's independence. In particular, the restriction on debtor-creditor relationships in Rule 2-01(c)(1)(ii)(A) (the "Loan Rule") currently 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 now defined, "audit client" includes every entity within the audit client's "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.

A registered investment company must distribute an annual report to its shareholders that is certified by a public accounting firm that is "independent," and that annual report is often incorporated into the investment company's

[1] *See* Fidelity Management & Research Company, SEC No-Action Letter (pub. avail. June 20, 2016) (available here).

registration statement filed with the SEC.[2] 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 respective 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 these and other funds was reported by the industry press and *The Wall Street Journal*.

In June 2016, the SEC staff issued a no-action letter to Fidelity Management & Research Company regarding application of the Loan Rule (the "Fidelity Letter"). The staff stated that it would not recommend enforcement action against Fidelity entities (including Fidelity registered funds and private funds) that relied on financial statements audited by an audit firm that was not in compliance with the Loan Rule to comply with the federal securities laws. The SEC staff's no-action assurances were subject to certain conditions specified in the Fidelity Letter, and the staff stated that the no-action letter would expire eighteen months after it was issued. Subsequently, in a September 2017 no-action letter, the SEC staff extended the no-action assurances in the Fidelity Letter until "the effectiveness of any amendments to the [Loan Rule] designed to address the concerns expressed in the [Fidelity Letter]."

II. The Proposed Amendments

The proposed amendments would effect four changes to the Loan Rule.

1. Focus the Analysis Solely on Beneficial Ownership

The Release states that, when the SEC adopted the Loan Rule in 2000, the SEC's concern extended to loans between an audit firm and audit client shareholders who had a "special and influential role" with the audit client. The SEC used the ten percent bright-line test of record or beneficial owners to identify shareholders with a special and influential role.

Currently, the Loan Rule is implicated when an audit firm's lender is a record owner of ten percent of an audit client's equity securities, regardless of whether the lender has the ability or economic incentive to influence the audit client. The Release notes that a broker-dealer, custodian or an intermediary omnibus account-holder for its customers may be a record owner exceeding ten percent but lack the ability or incentive to influence an audit client.

Accordingly, the SEC proposes to amend the Loan Rule to apply only to beneficial owners of the audit client's equity securities. The SEC believes that shifting the focus to ***beneficial*** owners would more effectively identify audit client shareholders who have a special or influential role with respect to the audit client and, therefore, would better capture debtor-creditor relationships that can impair an audit firm's independence.

2. Replace the Ten Percent Test with a Significant Influence Test

A. ***The New Test***

The SEC believes that a ten percent test – even when applied solely to beneficial owners – would be both over- and under-inclusive as a means to identify debtor-creditor relationships that may impair an audit firm's independence. The Release states that, instead, a "significant influence" test would more effectively identify shareholders having a special and influential role with an issuer and, therefore, would better capture debtor-creditor relationships that can impair an audit firm's independence.

The significant influence test would focus on a lender shareholder's ability to influence the policies and management of an audit client, and would be based on all facts and circumstances. The test would include

[2] In addition, certain private funds engage independent audit firms to enable their investment advisers to comply with Rule 206(4)-2 under the Investment Advisers Act (the "custody rule").

consideration of the level of a lender's beneficial ownership, but a bright-line percentage ownership test by itself would no longer be dispositive regarding an auditor's independence with respect to an audit client.

B. ***What is Significant Influence?***

The Release does not define the term "significant influence." However, the Release notes that, while undefined, the term has been used in other parts of the SEC's auditor independence rule (*i.e.*, Rule 2-01 of Regulation S-X) since 2000,[3] and that the SEC intends to use the term synonymously with the principles in existing guidance published by the Financial Accounting Standards Board ("FASB") in ASC 323.[4] The Release states that, for these reasons, the concept of significant influence is already familiar to audit firms and their clients.

Under the proposed "significant influence" test, an audit firm, with its audit client, would be required to consider whether a lender that is also a beneficial owner of the audit client's equity securities is able to exert significant influence over the audit client's operating and financial policies. The Release states that this would be a facts-and-circumstances test and, under the existing accounting framework, may be indicated in several ways, including (i) lender representation on the audit client's board of directors, (ii) lender participation in the audit client's policy-making processes, (iii) material transactions between the lender and audit client, (iv) sharing of managerial personnel between the lender and audit client or (v) technological dependency between the lender and audit client.

The Release cautioned that a lender's ownership interest would be considered relative to other shareholders, but cautioned that substantial or majority ownership of an audit client's voting stock by another shareholder would not necessarily preclude reaching the conclusion that a lender has the ability to exercise significant influence.

C. ***Twenty Percent Rebuttable Presumption***

ASC 323 establishes a rebuttable presumption that a shareholder beneficially owning at least twenty percent of an issuer's voting securities has significant influence over the issuer. The Release applies ASC 323 to audit clients such that a lender beneficially owning twenty percent or more of an audit client's voting securities would be presumed to have the ability to exercise significant influence over an audit client. Conversely, consistent with ASC 323, if a lender beneficially owns less than twenty percent of an audit client's voting securities, a rebuttable presumption arises that the lender does not have significant influence over the audit client.

D. ***Significant Influence with Respect to Funds***

The Release states, in the context of registered and private funds, the SEC believes that the operating and financial policies relevant to the significant influence test include a fund's investment policies and day-to-day portfolio management, including selecting, purchasing and selling and valuing portfolio investments, as well as the distribution of income and capital gains (collectively, "Portfolio Management Processes"). Critically, the Release states, "where the terms of the advisory agreement grant the adviser significant discretion with respect to the fund's [Portfolio Management Processes] and the shareholder does not have the ability to influence those [Portfolio Management Processes], significant influence generally would not exist."

In addition, the Release clarifies that the mere ability to vote on the approval of a fund's advisory contract or a fund's fundamental policies on a *pro rata* basis with a fund's other shareholders generally should not lead to the conclusion that a shareholder has significant influence. That said, the Release gives a counter-example. If a private fund shareholder has a side letter agreement permitting participation in Portfolio Management

[3] *See* Rule 2-01(c)(1)(i)(E)(1)(i), (E)(1)(ii), (E)(2), (E)(3), (f)(4)(ii) and (f)(4)(iii) of Regulation S-X.
[4] FASB, Accounting Standards Codification Topic 323: *Investments – Equity Method and Joint Ventures* ("ASC 323").

Processes, including participation on a fund's advisory committee, then the shareholder "would likely have significant influence."

3. Reasonable Inquiry Compliance Threshold

As discussed above, the Release recognizes that application of the existing ten percent test is difficult because a record owner exceeding ten percent may be a broker-dealer, custodian or an intermediary omnibus account-holder for its customers. The Release also notes that a beneficial owner may object to disclosure of its identity and securities position to an issuer, thereby making it impossible for issuers to obtain beneficial ownership information for these owners. Accordingly, the Release proposes to amend the Loan Rule to address issues arising from concerns about accessibility to information regarding beneficial ownership by adding a "known through reasonable inquiry" standard.

Under the proposed amendment, an audit firm, with its audit client, would be required to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry. The Release notes that the proposed "known through reasonable inquiry" standard is generally consistent with existing provisions of the federal securities laws, including Rule 502(d) of Regulation D (reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons) and Item 18 of Form N-1A (identification of persons who are known to own of record or beneficially" five percent of a fund's shares).

4. Excluding Other Funds that Would Be Considered Affiliates of the Audit Client

The existing definition of "audit client" under Rule 2-01 of Regulation S-X includes all affiliates of the audit client. Therefore, an audit firm's lack of independence with respect to one entity within an investment company complex (registered fund, private fund or other entity) due to a Loan Rule violation potentially renders the audit firm non-independent with respect to every entity within the investment company complex.

The Release notes that investors in a fund do not normally have the ability to affect the management of another fund in the same complex. Therefore, the Release also contains a proposed amendment that, for purposes of the Loan Rule, excludes from the definition of audit client any other funds that are considered an affiliate of the audit client.

III. Comments to SEC

Comments on the Release's proposed Loan Rule amendments must be received by the SEC no later than July 9, 2018.

IV. Observations

If the proposed amendments to the Loan Rule are adopted, an audit firm would still need to establish, and audit committees would still have to assess, the audit firm's independence. However, the proposed amendments should simplify analyses arising from potential Loan Rule violations of the type that led to the Fidelity Letter.

- For many or most registered funds, a ***record*** shareholder of twenty percent or more is the exception rather than the rule. Therefore, for these funds, even if an audit firm's lender appears among the less-than-twenty-percent record shareholders, a rebuttable presumption would apply regarding the lender's lack of significant influence.

- If a lender were a ***beneficial*** owner of twenty percent or more of a registered fund's shares, a rebuttable presumption would arise that the lender has significant influence over the audit client. However, in the fund context, the Release states that the SEC believes that, where the terms of the advisory agreement grant the adviser significant discretion with respect to the fund's Portfolio Management Processes, and the shareholder does not have the ability to influence those Portfolio Management Processes, significant influence generally would not exist. Thus, even with these facts, it should be possible to rebut the presumption that the lender has significant influence.[5]

The Release's proposal to amend the existing definition of "audit client" would prevent an audit firm's Loan Rule violation with respect to one entity within an investment company complex from automatically jeopardizing the audit firm's independence with respect to every entity within the complex. For obvious reasons, this amendment would be welcome.

Collectively, the proposed amendments to the Loan Rule should virtually eliminate the types of problems that led to the Fidelity Letter. However, an audit committee's regular dialogue with a fund's auditor, looking for issues that may jeopardize the auditor's independence, remains the best, first-line defense.

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

[5] Recall that the Release clarified that the mere ability to vote on the approval of a fund's advisory contract or a fund's fundamental policies on a *pro rata* basis with a fund's other shareholders generally should not lead to the conclusion that a shareholder has significant influence.