June 25, 2019

SEC Adopts Rule Change to Address Funds' Auditor Independence Problem

In a June 18, 2019 release (the "Release"), the SEC adopted amendments to the "Loan Rule" (as defined below), a part of the SEC's auditor independence rule, Rule 2-01 of Regulation S-X. The amendments, which were proposed in 2018, 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 acknowledges that "there are certain fact patterns in which an auditor's objectivity and impartiality are not impaired despite a failure to comply with the requirements of the [Loan Rule]" and, further, that these fact patterns have occurred most frequently with respect to both registered funds and private funds.

The Release adopts the amendments as proposed with minor changes. In particular, once effective, the Release's amendments will:

- Limit the analysis under the Loan Rule to beneficial ownership without considering record ownership;
- Replace the Loan Rule's ten percent "bright-line" shareholder record ownership test with a "significant influence" test applicable to beneficial owners, which includes a rebuttable presumption of significant influence for beneficial owners of at least twenty percent of a fund's equity securities;
- Apply a "known through reasonable inquiry" standard to identifying 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.

The Loan Rule, marked to show the Release's amendments, appears in the Appendix to this Alert.

The Release's amendments **will become effective 90 days after the date the Release is published in the *Federal Register***.[2] The Release is described in detail below.

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"), until amended, 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." The pre-amendment definition of "audit client" includes every entity within the audit client's "investment company complex." Therefore, without the Release's amendments, 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).
[2] As of June 25, 2019, the Release has not been published in the *Federal Register*.

registration statement filed with the SEC. In addition, private funds typically engage independent audit firms to enable their investment advisers to comply with Rule 206(4)-2 under the Advisers Act (the "custody rule"). 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.

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]."

Finally, in a May 3, 2018 release (the "2018 proposing release"), the SEC proposed amendments to the Loan Rule that are virtually identical to the amendments adopted in the Release.

The Amendments

Consistent with the 2018 proposing release, the Release's amendments make the following changes to the Loan Rule.

1. Focus the Analysis Solely on Beneficial Ownership

Until the amendments' effective date, 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 states that tailoring the Loan Rule to instead focus on the beneficial ownership of an audit client's equity securities "would more effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality," while excluding attenuated relationships that are unlikely to impair an audit firm. Therefore, the Release amends the Loan Rule to apply solely to beneficial owners of the audit client's equity securities.

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

A. The Significant Influence Test

The Release states that tailoring the Loan Rule's focus to beneficial owners of the audit client's equity securities "would more effectively identify shareholders 'having a special and influential role with the issuer' and therefore better capture those debtor-creditor relationships that may impair an auditor's independence." Accordingly, the Release amends the Loan Rule by adding a "significant influence" test to identify shareholders having "a special and influential role with the issuer."

B. What is Significant Influence?

The Release's amendments leave the term "significant influence" undefined. 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

[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.

guidance published by the Financial Accounting Standards Board ("FASB") in ASC 323.[4] The Release notes that the concept of "significant influence" is thus already familiar to audit firms and their clients.

In response to comments received by the SEC in response to the 2018 proposing release, the Release repeats guidance from the 2018 proposing release guidance regarding the application of the significant influence test in the fund context. According to the Release:

> [T]he 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 Release states that an audit firm's initial analysis under the Loan Rule could analyze whether a shareholder-creditor has significant influence over a fund's portfolio management processes exists based on, among other factors, an evaluation of (i) the fund's governance structure and governing documents, (ii) the manner in which its shares are held or distributed and (iii) any contractual arrangements. The Release further states that it is fitting for an audit firm to consider the nature of the services provided by a fund's investment adviser under the terms of the relevant investment management agreement. If that agreement provides the investment adviser with significant discretion concerning the fund's portfolio management processes, and no shareholder-creditor has power to influence those portfolio management processes, significant influence is unlikely to exist. This remains true even if a shareholder is the beneficial owner of twenty percent or more of the fund's equity securities (which otherwise triggers the rebuttable presumption described below). Additional analysis is not required, unless there is a material change to the fund's governance structure and governing documents. In addition:

- ***Concerning any registered fund***, 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.
- ***With respect to an ETF***, the Release states that the deposit or receipt of creation or redemption baskets by an authorized participant (an "AP") that is also a lender to the ETF's audit firm does not, by itself, give rise to significant influence over the ETF.
- ***In the case of a closed-end fund***, the Release states that holders of a fund's preferred stock that have certain rights can be relevant to a significant influence analysis. The Release cites to Section 18(a)(2)(C) of the 1940 Act, which generally provides that holders of a closed-end fund's preferred shares may elect directors if the dividend payments on their shares are not paid for two years.
- ***With respect to a private fund***, the Release reiterates guidance from the 2018 proposing release applicable to private funds. Specifically, the Release states, if a private fund shareholder has a side letter agreement that permits participation in the fund's portfolio management processes – including participation on a private fund advisory committee – then it is likely that the shareholder has significant influence. Moreover, because the responsibilities of advisory committees vary, the Release states that a private fund shareholder who participates on a fund advisory committee is more likely to have significant influence if the committee has substantive oversight responsibility or decision-making capacity over the operating and financial policies that are significant to the fund.

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

[4] FASB, Accounting Standards Codification Topic 323: *Investments – Equity Method and Joint Ventures* ("ASC 323").

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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.

3. Reasonable Inquiry Compliance Threshold

Consistent with the 2018 proposing release, the Release amends the Loan Rule such that an audit firm, with its audit client, is required to analyze beneficial owners of the audit client's equity securities who are "known through reasonable inquiry." The Release states that an audit firm and its client can undertake the reasonable inquiry analysis "by looking to the audit client's governance structure and governing documents, Commission filings about beneficial owners, or other information prepared by the audit client which may relate to the identification of a beneficial owner." The 2018 proposing release noted 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

Until the amendments' effective date, the definition of "audit client" under Rule 2-01 of Regulation S-X includes all affiliates of the audit client. Therefore, until that effective date, 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 amends the Loan Rule to exclude from the definition of audit client any other funds that are considered an affiliate of the audit client.

Additional Changes

Consistent with the 2018 proposing release's exclusion from the definition of "audit client" of all affiliates of the audit client, commenters urged the SEC to similarly exclude commodity pools that are part of an investment company complex. Therefore, the Release's amendments expand the definition of "fund" to provide that an affiliate commodity pool that is not an investment company or does not rely on Section 3 of the 1940 Act also is excluded from the definition of audit client.[5]

Observations

The Release's amendments to the Loan Rule still require an audit firm to establish, and an audit committee to assess, the audit firm's independence. However, the amendments, once effective, will simplify analyses arising from potential Loan Rule violations of the type that led to the Fidelity Letter.

1. 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 will apply regarding the lender's lack of significant influence.

2. If a lender were a ***beneficial*** owner of twenty percent or more of a fund's shares, a rebuttable presumption will arise that the lender has significant influence over the audit client. However, 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

[5] A commodity pool that is an investment company or that relies on Section 3 of the 1940 Act is already covered by the final amendments' fund exclusion.

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.[6]

3. The Release's amendment of the existing definition of "audit client" will 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 is much welcomed. Moreover, the Release extends this change to include commodity pools within the complex.

Collectively, once effective, the Release's 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 audit firm, looking for issues that may jeopardize the audit firm'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.

[6] Recall that 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.

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Amendments to Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Rule")

(ii) *Other financial interests in audit client.* An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) *Loans/debtor-creditor relationship*.

(*1*) Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or ~~record or~~ beneficial owners ~~of more than ten percent~~(known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(~~*1*~~*i*) Automobile loans and leases collateralized by the automobile;

(~~*2*~~*ii*) Loans fully collateralized by the cash surrender value of an insurance policy;

(~~*3*~~*iii*) Loans fully collateralized by cash deposits at the same financial institution; and

(~~*4*~~*iv*) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(*2*) For purposes of paragraph (c)(1)(ii)(A) of this section:

(*i*) The term *audit client* for a fund under audit excludes any other fund that otherwise would be considered an *affiliate of the audit client*;

(*ii*) 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 of 1940 (15 U.S.C. 80a-3(c)); or a commodity pool as defined in Section 1a(10) of the U.S. Commodity Exchange Act, as amended, that is not included in paragraph (c)(2)(ii)(a) of this section.

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