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## SEC Alleviates Compliance Challenges of Auditor Independence Loan Rule

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On June 18, 2019, the US Securities and Exchange Commission (SEC) adopted amendments to its auditor independence rules, specifically Rule 2-01(c)(1)(ii)(A) of Regulation S-X (Loan Rule), relating to situations in which an auditor has a lending relationship with certain shareholders of an audit client during the audit or professional engagement period (the corresponding adopting release is referred to herein as the Adopting Release).<sup>1</sup> The amendments to the Loan Rule (Amendments) are intended to more effectively identify lending relationships that could impair an auditor's objectivity and impartiality, as opposed to more attenuated relationships that are unlikely to pose such threats. The Amendments were originally proposed in May 2018 (the corresponding proposing release is referred to herein as the Proposing Release).<sup>2</sup>

The Amendments became effective on October 3, 2019. The version of the Loan Rule that was in effect prior to the effective date of the Amendments is referred to herein as the "Prior Loan Rule," while the current Loan Rule, which incorporates the Amendments, is referred to herein as the "Amended Loan Rule."

The key components of the Amendments remain largely unchanged from the proposed Amendments and include the following changes to the Prior Loan Rule:

- Focus the analysis on beneficial ownership of equity securities of an audit client rather than on both record and beneficial ownership.
- Replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test.
- Add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities.
- Exclude from the definition of "audit client," for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client.

In addition, the Adopting Release includes guidance regarding the application of the Amended Loan Rule with respect to identifying beneficial owners through reasonable inquiry and conducting the significant influence test, particularly in the fund context. This guidance should simplify the process of assessing whether lending relationships are implicated by the Amended Loan Rule.

The Adopting Release also notes that the SEC Chair has directed the Staff to formulate recommendations to the SEC for possible additional changes to the auditor independence rules in a future rulemaking.

## Background

### Auditor Independence and the Loan Rule

The US federal securities laws require SEC issuers and other registrants to file financial statements with the SEC that are audited by an independent registered public accounting firm,<sup>3</sup> while other entities engage independent public accounting firms to, *inter alia*, satisfy the conditions of Rule 206(4)-2 (that is, the Custody Rule) under the Investment Advisers Act of 1940, as amended.<sup>4</sup> Rule 2-01 of Regulation S-X, Qualifications of Accountants, sets forth standards for an accountant, including any affiliated accounting firms, to be deemed independent of its audit clients under the US federal securities laws.

Rule 2-01(b) provides that the SEC will not recognize an accountant as independent with respect to an audit client if the accountant is not, or if a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. Rule 2-01(c) sets forth a nonexclusive list of circumstances that the SEC considers to be inconsistent with the independence standard in Rule 2-01(b). Among other things, this includes certain direct financial relationships between an accountant and audit client and other

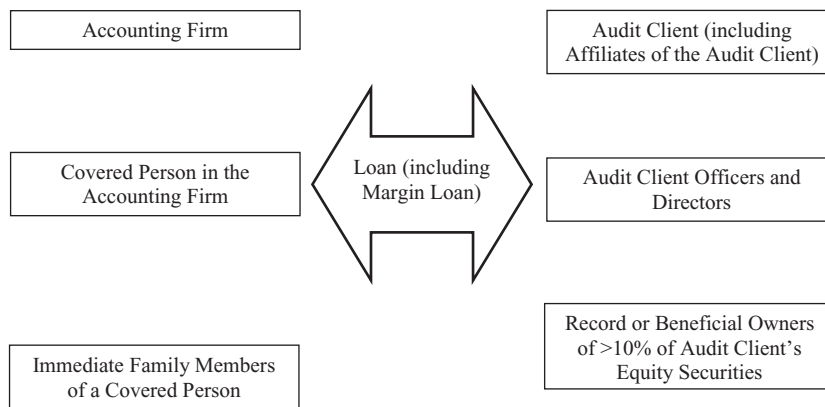
circumstances where the accountant has a financial interest in the audit client, including the Loan Rule. The SEC is concerned that such relationships may create a mutual or conflicting interest between the accountant and the audit client.<sup>5</sup>

In particular, the restriction on debtor-creditor relationships in the Prior Loan Rule generally provided that an accountant is not independent when the accounting firm, any covered person in the accounting firm (for example, the audit engagement team and those in the chain of command), or any of the covered person’s immediate family members has 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 10 percent of the audit client’s equity securities,<sup>6</sup> except for certain loans obtained from a financial institution under its normal lending procedures, terms, and requirements.<sup>7</sup>

The term “audit client” is defined in Rule 2-01(f)(6) to include the specific entity whose financial statements are being audited (that is, the entity that has engaged the services of the accounting firm), as well as any affiliates of the audit client. An “affiliate of the audit client” is broadly defined in Rule 2-01(f)(4) to include:

- Any entity that controls, is controlled by, or is under common control with the audit

### Exhibit 1



client, including the audit client's parents and subsidiaries.

- Any entity over which the audit client has significant influence, unless the entity is not material to the audit client.
- Any entity that has significant influence over the audit client, unless the audit client is not material to the entity.
- Each entity in the investment company complex of which the audit client is a part.<sup>8</sup>

As a result, generally, an accounting firm was not independent under the Prior Loan Rule if there was any lending relationship between any entity in the left-hand column of Exhibit 1 and any entity in the right-hand column, unless an exception applied.<sup>9</sup>

### **Loan Rule Concerns and Compliance Challenges**

In recent years, the SEC became aware that, in certain circumstances, the Prior Loan Rule may not have been functioning as intended; that is, to address concerns that a debtor-creditor relationship between an auditor and its audit client, or between the auditor and shareholders of the audit client who have a special and influential role with the audit client, created a competing self-interest for the auditor. The SEC recognized that there were certain fact patterns in which an auditor's objectivity and impartiality were not impaired despite a failure to comply with the requirements of the Prior Loan Rule.<sup>10</sup> In addition, the SEC acknowledged significant compliance challenges associated with meeting the requirements of the Prior Loan Rule, and that such challenges could have broader disruptive effects, particularly for funds that are required to make certain filings with the SEC that contain financial information audited by an independent registered public accounting firm.<sup>11</sup>

In June 2016, the SEC Division of Investment Management Staff issued a no-action letter to Fidelity Management & Research Company *et al.* that provided temporary relief for certain circumstances implicated

by the Prior Loan Rule, subject to conditions specified in the letter (Fidelity Letter).<sup>12</sup> The Fidelity Letter was to expire 18 months from the issuance date. In September 2017, the Staff extended the Fidelity Letter until the effective date of any amendments to the Prior Loan Rule adopted by the SEC that were designed to address the concerns expressed in the Fidelity Letter.<sup>13</sup> The proposed Amendments were then issued in May 2018, as noted above. The SEC received more than 30 comment letters from a variety of industry participants in response to the Proposing Release, most of which were supportive of the proposed Amendments.<sup>14</sup> The Fidelity Letter was withdrawn on October 3, 2019, the effective date of the Amendments.<sup>15</sup>

### **Final Amendments**

The SEC adopted the Amendments generally as proposed with a few additional changes and clarifications. The key changes to the Prior Loan Rule resulting from the Amendments are summarized below.

#### **Focus on Beneficial Ownership**

Under the Prior Loan Rule, when a lender to an auditor held more than 10 percent of the equity securities of that auditor's audit client, either as a beneficial owner or as a record owner, the auditor could be deemed not to be independent of the audit client. The SEC acknowledged that there were significant challenges associated with compliance monitoring for fluctuations in record ownership percentages (for example, open-end funds may have had difficulty monitoring underlying customer activity in an omnibus account).<sup>16</sup> Consistent with the proposed Amendments, the Amendments removed the reference to record ownership from the Prior Loan Rule and focused the analysis under the Amended Loan Rule solely on beneficial ownership of an audit client.

#### **Definition of "Beneficial Owner"**

The SEC provided guidance in the Adopting Release that financial intermediaries, who hold shares as record owners, and who have limited

authority to make or direct voting or investment decisions on behalf of the underlying shareholders of the audit clients, are not considered “beneficial owners” for purposes of the Amended Loan Rule.<sup>17</sup> The Adopting Release also states that a financial intermediary that removes its discretion over the voting or disposition of shares generally will not be considered a beneficial owner for purposes of the Amended Loan Rule. Steps to remove such discretion could include, for example:

- mirror voting (that is, the intermediary is obligated to vote the shares held by it in the same proportion as the vote of all other shareholders);
- the financial intermediary holds the shares in an irrevocable voting trust without discretion for the institution to vote the shares;
- an agreement to pass through the voting rights to an unaffiliated third-party entity; or
- the intermediary has otherwise relinquished its right to vote such shares.<sup>18</sup>

### **Control Exclusion**

Consistent with the Fidelity Letter and the Proposing Release, the SEC also confirmed in the Adopting Release that entities that are under common control with, or controlled by, the beneficial owner of the audit client’s equity securities when such beneficial owner has significant influence over the audit client, are excluded from the scope of the Amended Loan Rule.<sup>19</sup>

### **Significant Influence Test**

The SEC recognized that the bright-line 10 percent ownership test in the Prior Loan Rule may have been both over- and under-inclusive as a means of identifying those debtor-creditor relationships that actually impaired the auditor’s objectivity and impartiality (for example, a more than 10 percent record holder who was a lender may have been unable to influence the audit client through its holdings, while a lender who owned 10 percent or

less may have been able to exert significant influence over the audit client through contractual or other means).<sup>20</sup>

The Amendments replaced the 10 percent bright-line test in the Prior Loan Rule with a “significant influence” test similar to that referenced in other parts of the SEC’s auditor independence rules<sup>21</sup> and based on the concepts applied in Financial Accounting Standards Board Accounting Standards Codification Topic 323, Investments—Equity Method and Joint Ventures (ASC 323). The concept of “significant influence,” including the 20 percent rebuttable presumption (discussed below), has been a part of the SEC’s auditor independence rules since 2000 and part of the accounting standards since 1971.<sup>22</sup> Importantly, the Adopting Release provides guidance regarding application of the significant influence test in the fund context (discussed below), which may substantially simplify the process of determining whether an entity is able to exercise significant influence over a fund audit client under the Amended Loan Rule.

### **General Application of Significant Influence Test**

Under ASC 323, the ability of an investor to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

- representation on the board of directors;
- participation in policy-making processes;
- material intra-entity transactions;
- interchange of managerial personnel;
- technological dependency; and
- extent of ownership by the investor in relation to the concentration of other shareholdings.<sup>23</sup>

ASC 323 states that determining the ability of an investor to exercise significant influence is not always clear, and that applying judgment is necessary to assess the status of each investment.<sup>24</sup> However,

ASC 323 incorporates a rebuttable presumption of significant influence once beneficial ownership meets or exceeds 20 percent of an investee's voting securities, along with the converse presumption that significant influence does not exist where ownership is under 20 percent (referred to herein as the "20 percent rebuttable presumption").<sup>25</sup> ASC 323 also discusses various indicators that a 20 percent investor may be unable to exercise significant influence over the operating and financial policies of an investee.<sup>26</sup>

In an effort to avoid future confusion if changes are made to ASC 323, the SEC, in adopting the Amendments, did not codify the 20 percent rebuttable presumption or the specific considerations described in the significant influence test in ASC 323.<sup>27</sup> The Adopting Release also clarified that the determination of whether an entity has control of another entity is distinct from the determination of whether an entity has significant influence over another entity.<sup>28</sup>

The frequency and timing of the significant influence evaluation under the Amended Loan Rule should be based on the particular facts and circumstances relevant to the audited entity, consistent with the requirement that the auditor be independent throughout the audit and professional engagement period. The SEC has not prescribed specific dates, periods or circumstances upon which such significant influence evaluation should occur. The Adopting Release notes that, outside of the fund context (discussed below), audit firms and their audit clients should continue to monitor the auditor's independence on an ongoing basis by using their existing processes for determining whether significant influence exists consistent with the principles of ASC 323.<sup>29</sup>

### ***Application of Significant Influence Test in Fund Context***

The SEC believes that the concept of significant influence is one with which audit firms and their clients already are required to be familiar, but

it acknowledges that this concept is not as routinely applied by funds for financial reporting purposes.<sup>30</sup> In the context of funds, the SEC believes that the operating and financial policies relevant to the significant influence test would include a fund's investment policies and day-to-day portfolio management processes, including those governing the selection, purchase and sale, and valuation of investments, as well as the distribution of income and capital gains (collectively, the "portfolio management processes"). The SEC noted that an audit firm could analyze, in its "initial assessment" under the Amended Loan Rule, whether significant influence over the fund's portfolio management processes exists based on the following factors, among other relevant factors:

- An evaluation of the fund's governance structure and governing documents.
- The manner in which its shares are held or distributed.
- Any contractual arrangements.<sup>31</sup>

In addition, the SEC stated that it would be appropriate to consider the nature of the services provided by the fund's investment adviser(s) pursuant to the terms of an advisory contract with the fund as part of this analysis. The Adopting Release states that, in circumstances 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 and the evaluation of significant influence would be *complete*, unless there is a material change in the fund's governance structure and governing documents. The SEC noted that this should be the case *even if* the shareholder in question holds 20 percent or more of a fund's equity securities, which would otherwise trigger the 20 percent rebuttable presumption in ASC 323.<sup>32</sup>

The Adopting Release outlined the following situations that, alone, generally would not lead to the determination that a shareholder has significant influence:

- The ability to vote on the approval of a fund’s advisory contract or a fund’s fundamental policies on a *pro rata* basis with all shareholders of the fund.
- The ability to remove or terminate a fund’s advisory contract.
- For exchange-traded fund audit clients, the deposit or receipt of basket assets by an authorized participant (AP) or market maker (acting through an AP), where such AP or market maker is a lender to the auditor.<sup>33</sup>

The one example provided in the Adopting Release of “likely” significant influence was of a shareholder in a private fund having a side letter agreement outside of the standard partnership agreement that allows for participation in portfolio management processes; including participation on a fund advisory committee, if that committee involves substantive oversight responsibility or decision-making capacity over operating and financial policies significant to the fund. The SEC acknowledged that the responsibilities of an advisory committee can vary.<sup>34</sup>

The ability to vote on the election of a fund’s trustees or directors, or to vote on the ratification of the appointment of the fund’s auditor, is not identified in the Adopting Release as pertinent to a fund’s portfolio management processes or a determination of significant influence. Therefore, such voting power appears to be less relevant to a significant influence analysis under the Amended Loan Rule compared to the requirements of the Fidelity Letter.<sup>35</sup>

The SEC provided minimal guidance on the significant influence test for closed-end funds. Closed-end funds can issue preferred shares as well as common shares,<sup>36</sup> and preferred shareholders have special rights in addition to the voting rights they share with common shareholders on matters of joint

interest. The Adopting Release states, however, that preferred share rights may be relevant to a significant influence analysis and notes that the determination of whether preferred shareholders have significant influence over the fund would be based on an evaluation of the relevant facts and circumstances.<sup>37</sup>

With regard to timing in the fund context, if the auditor determines that significant influence over the fund’s management processes does not exist at the time of the initial application of the Amended Loan Rule, the auditor should monitor the applicability of the Amended Loan Rule on an ongoing basis.<sup>38</sup> The Adopting Release notes, however, that the auditor could satisfy this obligation by reevaluating its determination in response to a material change in the fund’s governance structure and governing documents, SEC filings about beneficial owners,<sup>39</sup> or other information of which the audit client or auditor becomes aware, which may implicate the ability of the beneficial owner to exert significant influence.<sup>40</sup>

### **Materiality Qualifier**

In connection with its re-evaluation of the Prior Loan Rule ownership test, the SEC also requested comment in the Proposing Release on whether a materiality qualifier should be included for the Amended Loan Rule, although not formally included in the proposed Amendments. In the context of the Loan Rule, a provision for assessing materiality could have operated, for example, such that an auditor’s independence would only be impaired as a result of certain relationships where the lender to the auditing firm has beneficial ownership in the audit client’s equity securities *and* that investment is material to the lender or to the audit client.<sup>41</sup> However, the SEC declined to adopt a materiality qualifier in connection with the Amendments.

### **Reasonable Inquiry Compliance Threshold**

The Amendments added a “known through reasonable inquiry” standard to the Prior Loan Rule, which requires audit firms, in coordination with

audit clients, to assess beneficial owners of the audit clients' equity securities who are known through reasonable inquiry. The Adopting Release notes that such inquiry should be conducted by looking to the audit clients' governance structure and governing documents, SEC filings about beneficial owners, or other information prepared by the audit clients which may relate to the identification of a beneficial owner.<sup>42</sup> As discussed in the Proposing Release, if an auditor does not know after reasonable inquiry that one of its lenders is also a beneficial owner of an audit client's equity securities, including because that lender invests in the audit client through one or more financial intermediaries, the auditor's objectivity and impartiality are unlikely to be impacted by its debtor-creditor relationship with the lender.<sup>43</sup> The SEC believes that the "known through reasonable inquiry" standard is generally consistent with regulations implementing other federal securities laws.<sup>44</sup>

### Exclusion of Affiliated Funds

In a significant narrowing of the Prior Loan Rule for fund audit clients, the Amendments excluded from the definition of "audit client" for purposes of the Amended Loan Rule, *for a fund under audit*, any other fund (for example, a "sister fund") that otherwise would be considered an affiliate of the audit client. As discussed earlier, the definition of "audit client" in Rule 2-01(f)(6) includes all "affiliates of the audit client," which broadly encompasses entities in a control or significant influence relationship with the audit client, as well as each entity in the audit client's investment company complex.<sup>45</sup>

The SEC acknowledged that, in the fund context, the expansive definition of audit client could result in an audit firm being deemed not to be independent as to a broad range of entities, even where an auditor does not audit those entities.<sup>46</sup> In addition, in the investment management context, investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex. Although an investor in

one fund in a series company can vote on matters put to shareholders of the company as a whole (for example, the election of the company's directors or proposed amendments to the company's governing documents), rather than only to shareholders of one particular series, even an investor with a substantial investment in one series would be unlikely to have a controlling percentage of voting power of the company as a whole. Also, auditors often have little transparency into the investors of other funds in an investment company complex, unless they also audit those funds.<sup>47</sup>

Consequently, the SEC intended to address some of the compliance challenges associated with the application of the Prior Loan Rule to funds by narrowing the definition of "audit client." The exclusions include any investment companies, private funds, and commodity pools that otherwise would be considered affiliates of the audit client (that is, the fund under audit) under the Amended Loan Rule.<sup>48</sup> The Adopting Release clarified that the following funds would also be covered by this exclusion:

- Foreign funds (that is, investment companies as defined in Section 3(a)(1)(A) of the 1940 Act that are organized outside of the United States, and that do not offer or sell their securities in the United States in connection with a public offering) that are part of an investment company complex.
- "Downstream" affiliates of excluded (sister) funds (that is, entities that would otherwise be included in the audit client definition solely by virtue of their association with an excluded sister fund).<sup>49</sup>

Many commenters on the proposed Amendments supported expanding the affiliates of the audit client exclusion to also exclude other *non-fund* affiliates in the investment company complex or private fund complex (for example, investment advisers, broker-dealers, and service providers, such as custodians, administrators, and transfer agents),

but the final exclusion in the Amendments is limited to fund affiliates.

## Other Potential Changes to Auditor Independence Rules

In addition to the proposed Amendments (and the materiality qualifier noted above), the Proposing Release also solicited comment on other changes to the Loan Rule and to the other auditor independence rules. These comments generally fall into the following categories:

- Relating to the Loan Rule, but not significant compliance challenges (for example, other types of loans that could be excluded from the Loan Rule, such as student loans).
- Broadly impacting provisions of the auditor independence rules, including the Loan Rule (for example, the definitions of “covered person” and “affiliate of the audit client”).
- Broadly impacting provisions of the auditor independence rules other than the Loan Rule (for example, suggestions to narrow the look-back period for domestic initial public offerings).<sup>50</sup>

As noted above, the SEC Chair has directed the Staff to formulate recommendations to the SEC for possible additional changes to the auditor independence rules in a future rulemaking, which suggests that certain circumstances that the SEC currently considers to be inconsistent with the independence standard in Rule 2-01(b) could be narrowed in the future.

## Practical Considerations

### Auditors and Audit Clients

The Amendments should reduce the number of relationships that fall within the scope of the Amended Loan Rule as compared to the Prior Loan Rule, which was one of the SEC’s stated objectives, particularly for fund audit clients. In addition, the process of identifying such relationships for many

funds should be significantly streamlined as a result of the guidance, provided in the Adopting Release, that auditors can look to a fund’s governing structure and governing documents, among other factors, to determine whether significant influence exists. Auditors of funds whose operating and financial policies<sup>51</sup> are administered by the fund’s adviser through a contractual relationship established by the fund’s board or similar governing body may be able to conclude, absent evidence to the contrary, that fund shareholders cannot exert significant influence over the fund. In this instance, the auditor may not be required to determine whether each of its lenders is a beneficial owner of the fund because the “significant influence” prong of the test would not be met for any shareholder.

Although the Adopting Release states that monitoring for significant influence should be ongoing, the Adopting Release provides guidance for funds that auditors may be able to satisfy this obligation by evaluating material changes to a fund’s governing structure and governing documents. Best practices likely will develop that will streamline the process of determining whether a fund has changed its governing structure or governing documents in a manner that could impact the significant influence test.

Registered closed-end funds that issue preferred shares may require additional analysis to determine whether the preferred shareholder holds any special rights or influence over the fund’s portfolio management process that could be considered significant influence. This analysis likely will center on the rights and preferences granted to preferred shareholders under the fund’s governing documents and in the preferred share offering documents.

### Audit Committees and Boards

The independence communications received by audit committees from auditors should contain fewer Loan Rule violations as a result of the Amendments; again, particularly for fund audit clients. Audit committees may nonetheless want to inquire about the process being applied by the auditor and audit



client to determine the ability of the auditor's lenders to exert significant influence over the audit client (including applicable affiliates) and determine beneficial ownership, if necessary, under the Amended Loan Rule.

Following the effectiveness of the Amendments on October 3, 2019, the relief provided by the Fidelity Letter for certain lending relationships implicated by the Prior Loan Rule is no longer available. Audit committees and boards should therefore evaluate whether any policies and procedures previously adopted to address compliance with the Prior Loan Rule and/or the Fidelity Letter should be amended or withdrawn.

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**Mr. DiClemente** and **Ms. Crovitz** are partners, and **Mr. Roeber** is Counsel in the Investment Management Group of Stradley Ronon Stevens & Young, LLP. Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. These materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of those who may be interested in the subject matter.

## NOTES

- <sup>1</sup> See *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release No. 33-10648 (June 18, 2019), 84 Fed. Reg. 32040 (July 5, 2019) (Adopting Release), available at <https://www.govinfo.gov/content/pkg/FR-2019-07-05/pdf/2019-13429.pdf>; see also Rule 2-01(f)(5) of Regulation S-X (defining the term "audit and professional engagement period").
- <sup>2</sup> *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release No. 33-10491 (May 2, 2018), 83 Fed. Reg. 20753 (May 8, 2018) (Proposing Release), available at <https://www.govinfo.gov/content/pkg/FR-2018-05-08/pdf/2018-09721.pdf>.

- <sup>3</sup> See, e.g., Section 30(e) of the Investment Company Act of 1940, as amended (the 1940 Act), and Rule 30e-1 thereunder (requiring registered investment companies to transmit annually to shareholders financial statements audited by an independent accountant).
- <sup>4</sup> The Custody Rule provides an audit exception to certain pooled investment vehicles, which includes, among other things, that the vehicle is subject to annual audit by an audit firm, and that audited financial statements are sent to investors on an annual basis.
- <sup>5</sup> See Preliminary Note to Rule 2-01 of Regulation S-X.
- <sup>6</sup> See Rule 2-01(f)(11) of Regulation S-X (defining the term "covered persons in the firm"); Rule 2-01(f)(13) (defining the term "immediate family members"); Rule 2-01(f)(6) (defining the term "audit client").
- <sup>7</sup> Specifically: (1) automobile loans and leases collateralized by the automobile; (2) loans fully collateralized by the cash surrender value of an insurance policy; (3) loans fully collateralized by cash deposits at the same financial institution; and (4) 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. See Rule 2-01(c)(1)(ii)(A)(1)–(4) of Regulation S-X.
- <sup>8</sup> This includes: (A) an investment company and its investment adviser or sponsor; (B) any entity controlled by or controlling such investment adviser or sponsor, or any entity under common control with the investment adviser or sponsor if the entity: (1) is itself 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; and (C) 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 aforementioned investment adviser or sponsor (under paragraph (A) or (B)). Note that an investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily

portfolio management and is subcontracted with, or overseen by, another investment adviser; and a sponsor, for purposes of this definition, is an entity that establishes a unit investment trust. *See* Rule 2-01(f) (14) of Regulation S-X.

<sup>9</sup> In the context of an investment company complex, the accounting firm's independence is thus impaired if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of any entity within the investment company complex, regardless of which entities in the investment company complex are audited by the accounting firm. *See* Adopting Release, *supra* n.1, at 32042.

<sup>10</sup> *See, e.g., id.*

<sup>11</sup> Non-compliance with the auditor independence rules in some cases could result in affected funds not being able to offer or sell shares, investors not being able to rely on affected financial statements, or funds (and indirectly their investors) having to incur the costs of re-audits. *See id.* at 32043.

<sup>12</sup> *See* Fidelity Management & Research Company *et al.*, SEC No-Action Letter (June 20, 2016), available at <https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm>.

<sup>13</sup> *See* Fidelity Management & Research Company *et al.*, SEC No-Action Letter (Sept. 22, 2017), available at <https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm>.

<sup>14</sup> *See* Comments on Proposed Rule: Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships, SEC, available at <https://www.sec.gov/comments/s7-10-18/s71018.htm> (last visited Oct. 16, 2019).

<sup>15</sup> *See* Adopting Release, *supra* n.1, at 32043 n.22.

<sup>16</sup> *See id.* at 32044-45.

<sup>17</sup> *See id.* at 32045. The SEC notes that such guidance does not interpret or alter Rule 13d-3 (Determination of Beneficial Owner) under the Securities Exchange Act of 1934. *Id.* at n.40.

<sup>18</sup> *See id.* at 32045-46.

<sup>19</sup> This guidance was initially addressed in the Fidelity Letter and the Proposing Release, and it was memorialized in the Adopting Release. *See* Fidelity Letter, *supra* n.12, at n.5; Proposing Release, *supra* n.2, at 20756 n.22; Adopting Release, *supra* n.1, at 32046.

<sup>20</sup> *See* Adopting Release, *supra* n.1, at 32046.

<sup>21</sup> As noted above, an "affiliate of the audit client" includes, *inter alia*, an entity over which the audit client has *significant influence*, unless the entity is not material to the audit client, and includes an entity that has *significant influence* over the audit client, unless the audit client is not material to the entity. *See* Rules 2-01(c)(1)(i)(E)(I)(i)-(ii), (E)(2), and (E)(3) of Regulation S-X.

<sup>22</sup> *See Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919 (Nov. 21, 2000), 65 Fed. Reg. 76008 (Dec. 5, 2000) (amending the Rule 2-01(f)(4) definition of "affiliate of the audit client" to include a significant influence test), available at <https://www.govinfo.gov/content/pkg/FR-2000-12-05/pdf/00-30244.pdf>; *see also* Accounting Principles Board (APB) Opinion No. 18 (Mar. 1971), which was codified at ASC 323.

<sup>23</sup> *See* ASC 323-10-15-6. ASC 323 notes that substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor.

<sup>24</sup> *See* ASC 323-10-15-7.

<sup>25</sup> Specifically: "An investment (direct or indirect) of 20 percent or more of the voting stock of an investee shall lead to a presumption that in the absence of predominant evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated." ASC 323-10-15-8.

<sup>26</sup> Such indicators include: (i) opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence; (ii)

the investor and investee sign an agreement (*e.g.*, a standstill agreement) under which the investor surrenders significant rights as a shareholder; (iii) majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor; (iv) the investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (*e.g.*, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails; or (v) the investor tries and fails to obtain representation on the investee's board of directors. ASC 323-10-15-10. ASC 323-10-15-11 emphasizes that none of the individual circumstances is necessarily conclusive that the investor is unable to exercise such significant influence.

<sup>27</sup> See Adopting Release, *supra* n.1, at 32046.

<sup>28</sup> See *id.* at 32050.

<sup>29</sup> See *id.* at 32049. Audit firms and their audit clients may wish to consider re-evaluating their existing processes for determining whether significant influence exists for consistency with the principles of ASC 323 and the Amended Loan Rule.

<sup>30</sup> See *id.* at 32046.

<sup>31</sup> See *id.* at 32049.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> One of the conditions of the Fidelity Letter was for an affected entity (*i.e.*, an audit client) to make a "reasonable inquiry" about the impact of the Loan Rule on its auditor's independence in connection with any proxy solicitation of shareholders of the affected entity involving the election of trustees or directors, the ratification of the appointment of the independent auditor, or other matters that could influence the objectivity and impartiality of the auditor.

<sup>36</sup> See Section 18(f)(2) of the 1940 Act.

<sup>37</sup> See Adopting Release, *supra* n.1, at 32049.

<sup>38</sup> *Id.*

<sup>39</sup> The reference to SEC filings in the Adopting Release is narrower than the corresponding guidance in the

Proposing Release, which referred to "publicly available information about beneficial owners." See, *e.g.*, Proposing Release, *supra* n.2, at 20761.

<sup>40</sup> See Adopting Release, *supra* n.1, at 32049.

<sup>41</sup> See, *e.g.*, Proposing Release, *supra* n.2, at 20764.

<sup>42</sup> See Adopting Release, *supra* n.1, at 32051.

<sup>43</sup> See *id.* at 32050 (referencing the Proposing Release).

<sup>44</sup> *Id.* at n.111. For example, registered investment companies are subject to a similar requirement to disclose certain known beneficial owners. See Item 18 of Form N-1A ("State the name, address, and percentage of ownership of each person who owns of record or is known by the Fund to own beneficially 5 percent or more of any Class of the Fund's outstanding equity securities."); see also Item 19 of Form N-2 ("State the name, address, and percentage of ownership of each person who owns of record or is known by the Registrant to own of record or beneficially five percent or more of any class of the Registrant's outstanding equity securities.").

<sup>45</sup> To be clear, the audit client exclusion only applies to a fund under audit. Where a corporate (non-fund) entity is under audit, the term "audit client" applied to such entity for purposes of the Amended Loan Rule does *not* exclude funds that would be considered "affiliate[s] of the audit client" under Rule 2-01(f)(4) of Regulation S-X.

<sup>46</sup> See Adopting Release, *supra* n.1, at 32051. For example, under the Prior Loan Rule, an audit firm (Firm A) could be deemed not to be independent as to an audit client under the following facts: Firm A audits an investment company (Fund A) for purposes of the Custody Rule. A global bank (Bank) has a greater than 10 percent interest in Fund A. Bank is a lender to a separate audit firm (Firm B), but has no lending relationship with Firm A. Firm B audits another investment company (Fund B) that is part of the same investment company complex as Fund A because it is advised by the same registered investment adviser as Fund A. Under these facts, Firm B would not be independent under the existing Loan Rule because the entire investment company complex would be "tainted" as a result of

Bank's investment relationship with Fund A. *See id.* at n.118.

<sup>47</sup> *See id.* at 32051.

<sup>48</sup> The exclusion for commodity pools was not included in the proposed Amendments.

<sup>49</sup> *See* Adopting Release, *supra* n.1, at 32052.

<sup>50</sup> *See id.* at 32053.

<sup>51</sup> As noted above, the relevant operating and financial policies for a fund include those governing the selection, purchase and sale, and valuation of investments, and the distribution of income and capital gains.

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