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SEC Adopts Amendments to Loan Rule

On June 18, 2019, the U.S. Securities and Exchange Commission (the “SEC”) adopted amendments to Rule 2-01 of Regulation S-X, the auditor independence rules, relating to situations in which an auditor has a lending relationship with certain shareholders of an audit client during an audit and professional engagement period (referred to as the “Loan Rule”).[1] The amendments to the Loan Rule (the “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.[2]

The key components of the Amendments remain largely unchanged from the proposed Amendments and include the following changes to the 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% 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 Release includes additional guidance regarding application of the 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 significantly simplify the process of determining whether lending relationships prohibited by the Loan Rule exist.

The 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, which suggests that certain Rule 2-01 independence exceptions could be narrowed in the future.[3]

The Amendments will become effective 90 days following their publication in the Federal Register.

I. Background

The Loan Rule[4] generally provides that an accountant is not independent when the accounting firm, any covered person in the accounting firm (e.g., the audit engagement team and those in the chain of command), or any of the covered person’s immediate family members has any loan to or from an audit client, or an audit client’s officers, directors, or record or beneficial owners of more than 10% of the audit client's equity securities, except for certain loans obtained from a financial institution under its normal lending procedures, terms, and requirements.[5]

The term "audit client" is defined in Rule 2-01 to include the specific entity whose financial statements are being audited, as well as any affiliates of the audit client. An "affiliate of the audit client" is broadly defined to include:

- Any entity that controls, is controlled by, or is under common control with the audit 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.[6]

As a result, generally, an accounting firm is not independent if there is any lending relationship between it, its covered persons and their immediate family members on the one hand; and the officers and directors of the audit client or an entity that owns beneficially or of record 10% or more of the equity securities of the audit client (including certain affiliates) on the other hand, unless an exception applies.[7]

In recent years, the SEC became aware that the Loan Rule may not be functioning as intended (i.e., where auditor objectivity and impartiality are not impaired despite a violation of the Loan Rule) and acknowledged significant compliance challenges associated with meeting the requirements of the Loan Rule. In June 2016, the SEC staff issued a no-action letter to Fidelity Management & Research Company that provided temporary relief for certain circumstances implicated by the Loan Rule.[8] The Release states that the Fidelity Letter will be withdrawn on the effective date of the Amendments.

II. Final Amendments

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

a. Focus on Beneficial Ownership

The Amendments remove the reference to "record" ownership from the Loan Rule and focus the analysis solely on beneficial ownership of an audit client. The SEC also provided guidance in the 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 Loan Rule. The Release also stated that a financial intermediary that removes its discretion over the voting or disposition of shares, such as by mirror voting, passing voting rights to an unaffiliated party or otherwise relinquishing or suspending its voting rights, generally will not be considered a beneficial owner for purposes of the Loan Rule. Consistent with the Fidelity Letter and the Proposing Release, the SEC also confirmed in the 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 Loan Rule.

b. Significant Influence Test

The Amendments replace the existing 10% bright-line ownership test in the Loan Rule with a "significant influence" test similar to that referenced in other parts of the SEC's auditor independence rules 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" has been part of the SEC's auditor independence rules since 2000 and part of the accounting standards since 1971.[9]

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 representation on the board of directors, participation in policy-making processes, material intra-entity transactions, interchange of managerial personnel, technology dependency, and extent of ownership by the investor in relation to the concentration of other shareholdings.

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. However, ASC 323 incorporates a rebuttable presumption of significant influence once beneficial ownership meets or exceeds 20% of an investee's voting securities, along with the converse presumption that significant influence does not exist where ownership is under 20%.[10] In adopting the Amendments, the SEC did not codify the 20% rebuttable presumption or the specific considerations described in the significant influence test in ASC 323, in an effort to avoid future confusion if changes are made to ASC 323. The Release also clarifies 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.

The frequency and timing of the significant influence evaluation 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.

Application of significant influence test in fund context. 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 referred to as portfolio management processes). The SEC noted that an audit firm could analyze, in its "initial assessment" under the 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.

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 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 notes that this should be the case even if the shareholder in question holds 20% or more of a fund's equity securities.

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

- 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 holders 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.

The one example provided in the 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 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 Release as pertinent to a fund's portfolio management processes or a determination of significant influence. Such voting power therefore appears to be less relevant to a significant influence analysis under the amended Loan Rule compared to the requirements of the Fidelity Letter.

The SEC provided minimal guidance on the significant influence test for closed-end funds. The 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.

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 Amendments, the auditor should monitor the Loan Rule on an ongoing basis. The 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, 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.

c. Reasonable Inquiry Compliance Threshold

The Amendments add a "known through reasonable inquiry" standard, which requires audit firms, in coordination with the audit clients, to assess beneficial owners of the audit client's equity securities who are known through reasonable inquiry. The Release notes that such inquiry should be conducted by looking to the audit client's governance structure and governing documents, SEC filings about beneficial owners, or other information prepared by the audit client which may relate to the identification of a beneficial owner. The SEC believes that the "known through reasonable inquiry" standard is generally consistent with regulations implementing other federal securities laws, such as Item 18 of Form N-1A and Item 19 of Form N-2.

d. Exclusion of Affiliated Funds

In a significant narrowing of the existing Loan Rule, the Amendments exclude from the definition of "audit client" for purposes of the Loan Rule, for a fund under audit, any other fund (e.g., a "sister fund") that otherwise would be considered an affiliate of the audit client. The SEC intended this narrowing to address some of the compliance challenges associated with application of the Loan Rule. The exclusions include any investment companies, private funds, and commodity pools that otherwise would be considered affiliates of the audit client under the Loan Rule.[11] The Release also clarified that a foreign fund that is part of an audit client's investment company complex and "downstream" affiliates of excluded (sister) funds are also excluded from the definition of audit client for purposes of the Loan Rule.

III. Practical Considerations

Auditors and audit clients. The Amendments should greatly reduce the number of relationships that fall within scope of the Loan Rule, which was one of the SEC's stated objectives. In addition, the process of identifying such relationships for funds should be significantly streamlined as a result of the guidance, provided in the 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[12] are administered by the fund's adviser through a contractual relationship established by the fund's board or similar governing body would presumably be able to conclude, absent evidence to the contrary, that fund shareholders cannot exert significant influence over the fund. In this instance, the auditor would 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 Release states that monitoring for significant influence should be ongoing, the Release is clear that auditors may be able to satisfy this obligation by evaluating material changes to a fund's governing structure and governing documents. Best practices will likely 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 will likely 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 far fewer Loan Rule violations as a result of the Amendments. Audit committees should nonetheless ensure that they understand 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 and, if necessary, beneficial ownership under the revised Loan Rule. Audit committees should also consider inquiring about the frequency and timing of such evaluations.

Following the effectiveness of the Amendments, the relief provided by the Fidelity Letter for certain lending relationships implicated by the Loan Rule will no longer be available. Audit committees, auditors and audit clients will need to evaluate whether to treat violations of the Loan Rule as de facto disqualifying events or to seek relief from the SEC's Office of Chief Accountant ("OCA") if the auditor maintains that the lender's relationship to the audit client would not impair the auditor's objectivity and impartiality. The Release did not address whether OCA will continue to be receptive to such inquiries but did discuss the SEC's belief that the revised Loan Rule will result in fewer conflicts and, therefore, a potentially larger set of eligible auditors for audit clients.

In addition, audit committees and boards should evaluate whether any policies and procedures previously adopted to address compliance with the Loan Rule and/or Fidelity Letter should be amended or withdrawn.

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[1] *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Release No. 33-10648 (June 18, 2019) (the "Release"), *available at* https://www.sec.gov/rules/final/2019/33-10648.pdf.

[2] *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) (the "Proposing Release"), *available at* https://www.govinfo.gov/content/pkg/FR-2018-05-08/pdf/2018-09721.pdf.

[3] In particular, the SEC did not adopt certain amendments discussed in the Proposing Release or suggested by commenters, including: an additional materiality screen, other types of loans that could be excluded from the Loan Rule, such as student loans; the definitions of "covered person" and "affiliate of the audit client" generally; and suggestions to narrow the look-back period for domestic initial public offerings.

[4] Rule 2-01(c)(1)(ii)(A) of Regulation S-X.

[5] 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.

[6] 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 7 Section 3(c) of the Investment Company Act of 1940, as amended, 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.

[7] 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% of any entity within the investment company complex, regardless of which entities in the investment company complex are audited by the accounting firm.

[8] *See* Fidelity Management & Research Company et al., SEC No-Action Letter (*pub. avail.* June 20, 2016) (the "Fidelity Letter"), *available at* https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm.

[9] *See Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919 (Nov. 21, 2000), 65 Fed. Reg. 76008 (Dec. 5, 2000) (*inter alia*, 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 Opinion No. 18 (March 1971), which was codified at ASC 323.

[10] ASC 323 also discusses various indicators that a 20% investor may be unable to exercise significant influence.

[11] The exclusion for commodity pools was not included in the proposed Amendments.

[12] 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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