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SEC Adopts Amendments to Auditor Independence Rules Addressing Lending Relationships

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On June 18, 2019, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 2-01 of Regulation S-X, which sets forth the SEC's auditor independence standards, changing the analysis of whether an audit firm is independent if it has a lending relationship with certain shareholders of an audit client at any time during an audit or other professional engagement period.[1] These rule amendments reflect extensive efforts over the last three years among the SEC, the fund industry and accounting firms to consider and address compliance concerns that arose as a result of the intersection of the application of the SEC's auditor independence standards to funds and fund complexes and the means by which accounting firms finance their core business operations.

The adopted rule amendments are largely consistent with the rule amendments proposed by the SEC in May 2018.[2] The amendments are intended to better identify those debtor-creditor relationships between an audit firm and its audit client[3] that are more likely to potentially implicate an accountant's independence, and reduce the amount of time and resources that audit firms, funds and their audit committees spend evaluating lending relationships under Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Provision") that are not likely to impair an auditor's objectivity and impartiality. In sum, the amendments:

- focus the independence analysis on beneficial (and not record) ownership of an audit client's equity securities;
- replace the existing 10% bright-line ownership test with a "significant influence" test;
- add a "known through reasonable inquiry" standard to identify beneficial owners of the audit client's equity securities; and
- exclude from the definition of "audit client," for a fund under audit, any other affiliated funds (including registered funds, private funds, non-U.S. funds and

commodity pools).

The adopted rule amendments will be effective 90 days after publication in the Federal Register. As of the date of this Client Alert, the rule amendments have not been published.

Background

The SEC's independence standards for auditors are set forth generally in Rule 2-01(b) of Regulation S-X, which provides that an auditor is not 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) of Regulation S-X provides a non-exhaustive list of those circumstances that the SEC considers to be inconsistent with an auditor's independence, including the circumstances outlined in the Loan Provision. In relevant part, an auditor is not independent under the current Loan Provision if it has a lending relationship with an entity having record or beneficial ownership of more than 10% of the equity securities of either (a) the fund under audit, (b) any entity that controls, is controlled by or is under common control with that fund or (c) any other entity in the fund's ICC.[4] Notably, under the current framework, a fund's auditor would not be considered independent under the Loan Provision if it has a lending relationship with an entity that has record or beneficial share ownership of more than 10% of any fund within the ICC, even if that fund is not audited by the same accounting firm.

Given the broad scope of the Loan Provision, the nature of ownership of many funds (where record ownership is often through a financial intermediary or institution, many of which have other business lines that provide debt financing), and the manner by which accounting firms finance their business operations (e.g., through syndicated bank borrowings or private placements of debt to financial institutions), starting in 2016, funds reported, both publicly and privately to the SEC, compliance concerns relating to the Loan Provision. In response to those concerns, the SEC staff issued a no-action letter providing relief from the Loan Provision's independence requirements under certain limited circumstances and subject to certain conditions, including that the auditor concluded that it was objective and impartial with respect to the issues encompassed by its engagement.[5] The no-action relief was set to expire 18 months after issuance (e.g., December 2017), but the SEC staff extended the relief until the effectiveness of any amendments to the Loan Provision intended to address the concerns outlined in the no-action letter (i.e., the rule amendments in the Adopting Release).

Final Amendments to the Loan Provision

The final amendments to the Loan Provision: (1) refocus analysis of independence of an accounting firm on a lender's beneficial ownership, rather than record ownership, of the firm's audit client; (2) replace the 10% ownership test with a "significant influence" test; (3) add a compliance threshold standard with respect to identifying beneficial owners of the audit client's equity securities that are "known through reasonable inquiry"; and (4) exclude from the definition of "audit client" funds that would otherwise be considered an "affiliate of the audit client," as well as commodity pools and non-U.S. funds.

Refocus Analysis on Beneficial Ownership. The rule amendments eliminate the concept of record ownership from the Loan Provision, meaning that the sole test is one of beneficial ownership of an audit client's equity securities. In response to requests from commenters, the SEC provided guidance in the Adopting Release on the scope of the term "beneficial owner" in the Loan Provision. The SEC stated that financial intermediaries who hold shares as record owner and have limited authority to make or direct voting or investment decisions are not beneficial owners under the Loan Provision.[6] The SEC also listed various means by which financial intermediaries could remove their discretion over the voting or disposition of shares and, as a result, generally would not be beneficial owners under the Loan Provision, including: (i) mirror or "echo" voting shares (i.e., the intermediary votes its shares in the same proportion as the vote of all other shareholders); (ii) holding shares in an irrevocable trust with no discretion to vote the shares; (iii) passing the voting of shares to an unaffiliated third-party; and (iv) relinquishing rights to vote the shares.

Adoption of "Significant Influence" Test. The rule amendments also replace the current 10% ownership test in the Loan Provision in favor of a "significant influence" test.[7] In noting that both auditors and audit committees of funds may benefit from guidance regarding the application of the significant influence test, the SEC indicated that an auditor's independence would be impaired if a lender had significant influence over 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. In the SEC's view, if the lender does not have the ability to influence portfolio management processes, the lender generally would not have significant influence, even if it holds 20% or more of a fund's equity securities.[8]

The SEC suggested that an auditor could analyze, including as part of its initial independence assessment under the Loan Provision, whether significant influence over a fund's portfolio management processes exists based on an evaluation of the fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements, among any other relevant factors. The SEC also noted that the frequency and timing of the significant influence evaluation should be based on the particular facts and circumstances of the audit or professional engagement. As a result, audit firms and their fund clients should work together to reevaluate initial determinations as to independence in response to material changes to the fund's governance structure and governing documents, SEC filings about beneficial owners or when the auditor or fund become aware of other information which may implicate the ability of a beneficial owner to exert significant influence.

In the Adopting Release, the SEC also clarified that the following examples alone should not lead to a determination that a shareholder has significant influence: (1) the ability to vote on the approval of a fund's advisory contract or fundamental policies pro rata with other shareholders; (2) the ability to remove or terminate an advisory contract; and (3) the deposit or receipt of basket assets by an authorized participant (or a market maker acting through such authorized participant) of an exchange-traded fund that is a lender to the auditor.

Reasonable Inquiry Compliance Threshold. The SEC acknowledged the difficulties inherent in accessing information about ownership percentages and, as a result, the amendments to the Loan Provision will require auditors and funds to conduct a reasonable inquiry to determine beneficial owners by analyzing the audit client's governance structure, SEC filings or other information prepared by the fund (or its investment adviser) which may relate to the identification of a beneficial owner. In setting this reasonableness standard, the SEC noted that, if an auditor conducts a reasonable inquiry and cannot determine that one of its lenders is also a beneficial owner of an audit client's securities (i.e., because the ownership stake is held indirectly or held through multiple financial intermediaries), such ownership is unlikely to affect the auditor's objectivity and impartiality during the course of the professional engagement and should not impair the accounting firm's independence.

Narrowing of "Audit Client" Definition. As noted above, the current definition of "audit client" includes all affiliates of the audit client, which, for funds, broadly encompasses each entity in a fund's ICC. The SEC acknowledged that investors in a fund, including a lender to an auditor, typically do not possess the ability to influence the policies or management of other funds in the ICC, including other funds in a series trust (a structure often used by mutual funds).

As a result, consistent with the proposed rule amendments, the final rule amendments to the Loan Provision exclude from the definition of "audit client," 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 also expanded the definition of "fund" for purposes of the Loan Provision to include, not only investment companies (including business development companies) and private funds relying on an exclusion from registration as an investment company under Section 3(c) of the 1940 Act, but also (i) commodity pools that are not investment companies and do not rely on such an exclusion and (ii) foreign funds that are part of the ICC.[9]

Potential for Additional Rulemakings and Initial Next Steps

These rule amendments are intended primarily to address the immediate compliance challenges created by the technical application of the current Loan Provision that had been raised by the fund industry and the accounting firms over the last three years. In the Adopting Release, the SEC noted that Chairman Clayton has directed the SEC staff to formulate recommendations to the SEC for possible additional changes to the auditor independence rules in a future rulemaking.[10]

Audit firms and funds, along with their investment advisers and audit committees, should note the SEC's emphasis that auditor independence is a shared responsibility between the audit firm and the audit client. Overall, the rule amendments will narrow substantially the entities that an auditor and funds must evaluate for purposes of assessing the auditor's independence, but are not meant to eliminate the diligence that needs to be undertaken to provide adequate assurance of an auditor's ongoing qualification to serve as a fund's independent registered public accounting firm. Audit committees should plan to discuss the rule amendments with their funds' auditors and, among other things, inquire as to whether they should receive updated letters that reflect the audit firm's independence under the amended Loan Provision.

[1] Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships , Investment Company Act Release No. 33511 (the "Adopting Release"). This Client Alert focuses on the implications of the final rule amendments to audit clients that are investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"), or business development companies (collectively referred to herein as "funds"), although these amendments equally apply to non-fund entities.

[2] Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships , 83 Fed. Reg. 20753 (May 6, 2018) (the "Proposing Release").

[3] Under Rule 2-01(f)(6) of Regulation S-X, the term "audit client" is defined to include any "affiliate of the audit client," which includes any affiliate of the fund whose financial statements are being audited, including entities that control, are controlled by or are under common control with that fund, as well as each other entity in the fund's investment company complex ("ICC").

[4] The Loan Provision also more broadly covers loans to or from any covered person in the accounting firm (e.g., the audit engagement team and those in the chain of command) and such covered person's immediate family members, and the audit client and the audit client's directors or officers. Most of the compliance concerns, however, have been focused on loans from 10% owners of an audit client's equity securities to the audit firm.

[5] Fidelity Management & Research Company et al., SEC Staff No-Action Letter (pub. avail. June 20, 2016).

[6] The SEC clarified, however, that this guidance is not interpreting Rule 13d-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") (defining "beneficial owner" for purposes of Section 13 of the Exchange Act and the rules thereunder), applying the existing standards for determining who is a beneficial owner under Rule 13d-3, or otherwise altering those standards. Adopting Release at 20, n. 40.

[7] The SEC noted that although the term "significant influence" is not specifically defined in the Loan Provision, the term appears in other parts of Rule 2-01 of Regulation S-X, and that the term was intended to refer to the principles in the Financial Accounting Standards Board's ASC Topic 323, Investments–Equity Method and Joint Ventures ("ASC 323"). Adopting Release at 22, 31. The SEC, however, did not codify either the (i) specific considerations described in the significant influence test in ASC 323 or (ii) rebuttable presumption of significant influence once beneficial ownership meets or exceeds 20% of an issuer's voting securities in the amendments to the Loan Provision.

[8] The SEC did, however, highlight the potential need for additional inquiry with respect to holders of preferred securities issued by a closed-end fund, as the rights of those holders may be relevant to a significant influence analysis. Adopting Release at 34. Similarly, investors in private funds that have side letter agreements or participating rights on a fund advisory committee may have significant influence depending on the degree to which the investor can influence the fund's portfolio management processes and exercise decision-making capacity over the fund's operating and financial policies. Adopting Release at 33.

[9] The SEC declined requests from commenters to exclude downstream affiliates of excluded funds, as the SEC did not believe an express exclusion in the definition of "fund" was necessary. The SEC did clarify that, for purposes of the Loan Provision, the exclusion of sister funds from the audit client definition also excludes entities that would otherwise be included in the audit client definition solely with an excluded sister fund (i.e., entities that control, are controlled by, or are under common control with the audit client). Adopting Release at 45-46.

[10] The Proposing Release had solicited comment on other changes to the Loan Provision and to the other auditor independence rules, including those: (i) generally relating to the Loan Provision (e.g., other types of loans that commenters suggested should be excluded from the Loan Provision, such as student loans); (ii) broadly impacting provisions of the auditor independence rules, including the Loan Provision (e.g., comments relating to the "covered person" and "affiliate of the audit client" definitions); and (iii) broadly impacting provisions of the auditor independence rules other than the Loan Provision (e.g., suggestions to narrow the look-back period for domestic initial public offerings so that the period is similar to that for foreign private issuers).