SEC PROPOSES PERMANENT SOLUTION TO LOAN RULE ISSUES FOR INVESTMENT COMPANIES

Date: 6 June 2018

U.S. Investment Management Alert

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SUMMARY

On May 2, 2018, the Securities and Exchange Commission ("SEC") proposed amendments to part of the SEC's auditor independence rules, Rule 2-01(c)(1)(ii)(A) of Regulation S-X, otherwise known as the "Loan Rule" (the "Proposing Release"). [1]

The proposed amendments are designed to refocus the analysis of an auditor's independence when the auditor has a lending relationship with certain shareholders and persons associated with an audit client. The SEC determined to reassess the Loan Rule after becoming aware that, in the context of investment companies (or "funds"), its application was presenting significant practical challenges and that it may not have been functioning as intended. The Proposing Release also recognized that "there are certain fact patterns where an auditor's objectivity and impartiality is not impaired despite a failure to comply with the [Loan Rule]."

The proposed amendments would make four important changes to the Loan Rule: (1) focus its analysis solely on beneficial (and not record) ownership; (2) replace the existing 10-percent shareholder ownership threshold with a "significant influence" test; (3) establish a "reasonable inquiry" standard with respect to due diligence; and (4) exclude from the definition of "audit client" funds that are "affiliates of the audit client." This client alert discusses the background of the Loan Rule, certain issues with its application, and the SEC's proposed amendments.

BACKGROUND

The Loan Rule and Funds

Rule 2-01 of Regulation S-X requires auditors to be independent of their audit clients both "in fact and in appearance." The SEC will not recognize an auditor as independent with respect to an audit client if the auditor "is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the [auditor] is not, capable of exercising objective and impartial judgment on all issues encompassed" within the auditor's engagement. [2] The SEC has stated that this involves assessing whether an arrangement "creates a mutual or conflicting interest between the [auditor] and audit client." [3]

Rule 2-01 sets forth a nonexclusive list of arrangements the SEC deems inconsistent with auditor independence. The Loan Rule is one of the listed arrangements and currently establishes that an auditor "is not independent if, at

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any point during the audit and professional engagement period, the [auditor] has a direct financial interest or a material indirect financial interest in the [auditor's] audit client…." [4]

Potentially disqualifying financial interests include "[a]ny 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 of the audit client's equity securities…." [5] The SEC has exempted certain types of routine loans made by lenders under normal lending procedures and requirements.

Rule 2-01 broadly defines "audit client" in the fund context. It provides that an audit client includes each fund in a fund complex that also includes the audit client. [6] The rule defines fund complex to include: (1) each fund and its investment adviser or sponsor; (2) any entity controlled by, controlling, or under common control with any such investment adviser if the entity is an investment adviser, or provides administrative, custodian, underwriting, or transfer agent services to any fund or investment adviser ("Adviser Affiliates"); and (3) certain private funds in the same fund complex. [7]

When one fund is affected by a Loan Rule violation, the definition could be interpreted as potentially triggering a Loan Rule violation with respect to every other fund and Adviser Affiliate in the fund complex. The definition could also be interpreted to trigger a violation even for funds in a fund complex that are audited by a different auditor.

The preliminary notes to Rule 2-01 establish that determination of an auditor's independence depends on the "particular facts and circumstances" at issue. [8] Prior to the June 2016 no-action letter granted by the SEC staff to Fidelity Management & Research Company ("Fidelity") (the "Fidelity Letter"), [9] this fact-based analysis led to sharply different interpretations as to the application of the Loan Rule. For example, some auditors reportedly took the position that fund shares are not securities for purposes of the Loan Rule. Under that interpretation, an auditor's lender with record or beneficial ownership of more than 10 percent of the outstanding shares of an audit client would not be subject to the Loan Rule. In addition, some auditors reportedly took the position that shares held in an omnibus custodial account were not held "of record or beneficially" and were therefore not considered in any analysis under the Loan Rule. These different interpretations resulted in varying applications of the Loan Rule and varying content in reports made to funds and their audit committees. The Fidelity Letter provided insight into the SEC staff's position regarding the application of the Loan Rule. Following the release of the Fidelity Letter, reporting to fund boards and their audit committees increased and was much more consistent among auditors.

The Fidelity Letter

In June 2016, Fidelity requested no-action relief after it learned that the auditor for some of its funds had loans outstanding from financial institutions that owned of record more than 10 percent of the voting securities of certain funds in the Fidelity funds complex. In the Fidelity Letter, the SEC staff stated that it would not recommend enforcement action if a fund or an Adviser Affiliate within the fund complex continues to use an auditor under such circumstances as long as the following conditions are met:

- The auditor complies with the Public Company Accounting Oversight Board's ("PCAOB") independence rules. These rules require an auditor to provide its clients with a written description of any relationships between the auditor and the client that may reasonably bear on its independence. PCAOB rules also require that an auditor discuss the potential effects of such relationships with the client's audit committee.
- The auditor's noncompliance with the Loan Rule relates solely to the lending relationship.

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- Notwithstanding its noncompliance with the Loan Rule, the auditor concludes that it is "objective and impartial" with respect to all issues encompassed within its engagement. [10]
- The auditor's lender does not exercise discretionary voting authority with respect to the fund shares at issue.

The Fidelity Letter expressly provides relief for the following situations that have been problematic: (1) when an auditor's lender holds of record (including in an omnibus or custody account) for its clients more than 10 percent of the shares of an audit client; (2) when an auditor's lender is an insurance company that holds more than 10 percent of the shares of an audit client in a separate account; and (3) when an auditor's lender acts as an authorized participant or market maker for an exchange-traded fund ("ETF") and, as such, holds more than 10 percent of the shares of an ETF that is an audit client.

Although the Fidelity Letter provided some clarification regarding the application of the Loan Rule, it left open a number of important questions. [11] In addition, the relief was issued on a temporary basis, assumingly to allow the SEC more time to consider a permanent solution. The proposed amendments attempt to address many of those concerns on a permanent basis.

SUMMARY OF PROPOSED AMENDMENTS

In the Proposing Release, the SEC posited that "numerous violations of the independence rules that no reasonable person would view as implicating an auditor's objectivity and impartiality could desensitize market participants to other, more significant violations of the independence rules." In this regard, the SEC acknowledged that "[r]espect for the seriousness of these obligations is better fostered through limiting violations to those instances in which the auditor's independence would be impaired in fact or in appearance." The SEC believes the proposed amendments to the Loan Rule would effectively identify lending arrangements that could impair an auditor's objectivity and impartiality and would not capture certain extended relationships that are unlikely to present such threats. The proposed amendments would make four important changes to the Loan Rule:

1. Focus the analysis solely on beneficial (and not record) ownership;
2. Replace the existing 10-percent shareholder ownership threshold with a "significant influence" test;
3. Establish a "reasonable inquiry" standard with respect to due diligence; and
4. Exclude from the definition of "audit client" funds that are "affiliates of the audit client."

Focus on Beneficial Ownership

The proposed amendments would limit application of the Loan Rule to beneficial owners of the audit client's securities and not to those who merely maintain the audit client's securities *as a holder of record* on behalf of their beneficial owners. The SEC believes that this would more effectively identify shareholders "having a special and influential role with the issuer" and therefore better capture those lending relationships that may impair an auditor's independence.

The Proposing Release notes that the Loan Rule has been unnecessarily applied where a lender holds an audit client's shares of record but the lender is unable to influence the audit client. However, the Proposing Release

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does not contemplate scenarios where a lender beneficially owns more than ten percent of an audit client's shares and has undertaken to limit its discretion to vote those shares (*e.g.*, shares are held in an irrevocable voting trust without discretion for the lender, the lender agreed to mirror vote the shares, the lender agreed to pass through the vote to an unaffiliated third-party entity, or the lender otherwise relinquished its right to vote such shares).

Significant Influence Test

The proposed amendments would replace the existing bright-line 10-percent shareholder ownership threshold with a "significant influence" test similar to other parts of the auditor independence rules. Specifically, the proposed amendments would provide that an auditor would not be independent when the auditor, any covered person in the audit firm, or any of his or her immediate family members, has any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's securities where such beneficial owner has significant influence over the audit client.

The "significant influence" test would require an auditor to assess whether a lender, that is also a beneficial owner of the audit client's securities, has the ability "to exert significant influence over the audit client's operating and financial policies." Although not specifically defined, the term "significant influence" appears in other parts of Rule 2-01. The SEC makes clear that "significant influence" is intended to refer to the principles in the Financial Accounting Standards Board's ASC Topic 323, Investments – Equity Method and Joint Ventures ("ASC 323").

The ability to exercise significant influence over the operating and financial policies of an audit client would be based on a "totality of facts and circumstances." The SEC notes that "significant influence" could be indicated in many ways, including: (1) representation on the board of directors; (2) participation in policy-making processes; (3) material intra-entity transactions; (4) interchange of managerial personnel; or (5) technological dependency.

The lender's beneficial ownership of an audit client's securities also would be considered in determining whether a lender has significant influence over an audit client's operating and financial policies. However, the significant influence test would not utilize a bright-line threshold. Instead, consistent with ASC 323, the test would establish a rebuttable presumption that a lender that beneficially owns 20 percent or more of an audit client's voting securities has the ability to exercise significant influence over the audit client. Conversely, if the ownership was less than 20 percent, there would be a rebuttable presumption that the lender does not have significant influence over the audit client. Thus, significant influence could exist in circumstances where ownership is less than 20 percent.

ASC 323 lists several indicators that would suggest that a shareholder who owns 20 percent or more of the audit client's voting securities may still be unable to exercise significant influence over the operating and financial policies of the audit client.

The SEC believes that the operating and financial policies relevant in the fund context would include the fund's "portfolio management processes"; for example, "investment policies and day-to-day portfolio management including those governing the selection, purchase and sale, and valuation of investments, and the distribution of income and capital gains." The SEC also believes that the nature of the services provided by the fund's adviser pursuant to the terms of the advisory agreement should also play a part in the analysis. As an example, the SEC stated that where an adviser has significant discretion over the portfolio management processes and the shareholder does not have the ability to influence those portfolio management processes, the shareholder

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generally would not have significant influence over the audit client. In addition, the ability to vote on the approval of a fund's advisory contract or fundamental policies on a pro rata basis with all holders of the fund alone generally would not lead to the determination that a shareholder has significant influence over the audit client.

In circumstances where significant influence could exist, the auditor would then evaluate whether the entity has the ability to exercise significant influence over the audit client and has a lending relationship with the auditor, any covered person in the firm, or any of his or her immediate family members. If the auditor determines that significant influence does not exist at the time of the initial evaluation, the SEC believes that the auditor should monitor compliance with the Loan Rule on an ongoing basis. [12]

Reasonable Inquiry Compliance Standard

The proposed amendments would address concerns about accessibility to records or other information about beneficial ownership by adding a "known through reasonable inquiry" standard with respect to the identification of beneficial owners. An auditor, in coordination with its audit client, would be required to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry. The SEC noted that the "known through reasonable inquiry" standard is generally consistent with the federal securities regulations and therefore should be a familiar concept. However, the extent to which funds might have to collect and retain records on ownership interests is not clear and should be clarified.

Excluding Other Funds That Are Affiliates of the Audit Client

The proposed amendments would exclude from the definition of audit client any fund affiliated with the audit client. This would address compliance challenges associated with application of the current version of the Loan Rule in the fund context, such as when an auditor is engaged for only one fund within a fund complex, and the auditor must be independent of every other fund (and other entity) within the fund complex, regardless of whether the auditor audits that fund.

COMMENT PERIOD

The SEC has requested comments by July 9, 2018. If the amendments are adopted as proposed, only loans associated with beneficial owners of the outstanding shares of an audit client will be reported to boards and their audit committees. The Loan Rule analysis will be based on practical principal based standards already found in the auditor rules. The proposed amendments should significantly reduce the unnecessary reporting of matters highly unlikely to affect an auditor's independence. Interestingly, the SEC is soliciting comments not only on the proposed amendments but also more broadly on other provisions in Rule 2-01 as deemed appropriate by commenters. This provides an exceptional opportunity for the fund industry and auditors to recommend changes to eliminate regulatory burdens imposed by other rules that do not deliver commensurate benefits by meaningfully protecting or strengthening auditor independence.

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[1] *See* Auditor Independence with respect to Certain Loans or Debtor-Creditor Relationships, Investment Company Release No. IC-33091 (May 3, 2018) (available at https://www.sec.gov/rules/proposed/2018/33-10491.pdf).

[2] Rule 2-01(b) of Regulation S-X.

[3] Preliminary Note 2 to Rule 2-01 of Regulation S-X.

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

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

[6] Rule 2-01(f)(6) of Regulation S-X defines "audit client" as "the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client." "Affiliates of the audit client" is defined in Rule 2-01(f)(4) to include those entities that control, are controlled by, or are under common control with the audit client and "[e]ach entity in the investment company complex when the audit client is an entity that is part of an investment company complex."

[7] Rule 2-01(f)(14) of Regulation S-X.

[8] Preliminary Note 3 to Rule 2-01 of Regulation S-X.

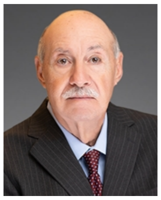
[9] Fidelity Management & Research Company, SEC No-Action Letter (June 20, 2016).

[10] Fidelity Letter at 6.

[11] *See* "Making Sense of Auditor Independence Issues" dated October 17, 2016, for further discussion and analysis regarding the Loan Rule, Fidelity Letter, and Investment Company Institute Frequently Asked Questions http://www.klgateshub.com/files/Publication/c061e86a-f8b0-4046-925c-dc262d6cf747/Presentation/PublicationAttachment/331a5d4e-eed7-4e7f-b6e4-e5473ef290dd/IM_Alert_10172016.pdf.)

[12] The Proposing Release provides that this could be accomplished by reevaluating the determination when there is a "material change in the fund's governance structure and governing documents, publicly available information about beneficial owners, or other information that may implicate the ability of a beneficial owner to exert significant influence of which the audit client or auditor becomes aware."

KEY CONTACTS



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