

July 9, 2018

Mr. Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships*  
(File No. S7-10-18)

Dear Mr. Fields:

The Investment Company Institute<sup>1</sup> and the Independent Directors Council<sup>2</sup> applaud the Securities and Exchange Commission’s proposed amendments to refine the auditor independence analysis that must be conducted when an auditor has a lending relationship with certain shareholders of an audit client.<sup>3</sup> The SEC proposed the amendments to Rule 2-01(c)(1)(ii)(A) of Regulation S-X, otherwise known as the “Loan Provision,” after becoming aware that there are certain fact patterns in which an auditor’s objectivity and impartiality are not impaired despite a technical failure to comply with the rule. We strongly agree that the Loan Provision is not functioning as intended and commend the Commission for its efforts to refocus the provision on those lending relationships that may present a legitimate threat to an auditor’s independence.

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<sup>1</sup> The [Investment Company Institute](#) (“ICI”) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (“ETFs”), closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s members manage total assets of US\$22.0 trillion in the United States, serving more than 100 million US shareholders, and US\$7.6 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](#), with offices in London, Hong Kong, and Washington, DC.

<sup>2</sup> The [Independent Directors Council](#) (“IDC”) serves the US-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC’s activities are led by a Governing Council of independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

<sup>3</sup> See *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships*, SEC Release No. IC-33091, 83 Fed. Reg. 20753 (May 8, 2018) (“Proposing Release”), available at <https://www.gpo.gov/fdsys/pkg/FR-2018-05-08/pdf/2018-09721.pdf>.

## I. Background and Summary of Comments

As the Proposing Release illustrates, the Loan Provision broadly deems a number of common scenarios involving auditor financing arrangements and customary fund distribution methods to impair an auditor's independence, notwithstanding relevant facts and circumstances that suggest otherwise. Over the past several years, these scenarios have caused auditors, fund directors, investment adviser personnel, and personnel at affiliated public companies of those investment advisers to devote substantial time and resources in identifying and assessing potential instances of noncompliance. The time and resources devoted to identifying and assessing potential instances of non-compliance provide no corresponding benefit to funds or their shareholders when the Loan Provision's breadth identifies technical violations that cannot affect the auditor's independence.

Fund board audit committees have spent a significant amount of time and resources working with their auditors to analyze circumstances that may trigger a technical violation of the Loan Provision, but do not have any practical effect on the auditor's objectivity and impartiality. Funds and their shareholders will be better served when fund audit committees can focus their time and energy on legitimate threats to independence, as well as the fund's accounting, financial reporting, and internal control processes. In addition, researching for technical violations of the rule is an expense that could result in increased audit fees to the detriment of fund shareholders.

Violations of the Loan Provision create particular challenges for registered funds. All funds are required to annually file financial statements audited by an *independent* accountant. All funds also are affected by the broad definition of "audit client," which, combined with the fact that funds typically are offered as part of a family of related funds, causes technical violations of the Loan Provision relating to one particular fund to impair the auditor's independence with respect to all funds in the "investment company complex," as well as the fund's investment adviser.

For these reasons, we strongly support the proposed amendments to the Loan Provision as well as the discussion and statements in the Proposing Release that describe how audit firms and funds should analyze lending relationships. Still, we believe that the Commission could improve the proposed amendments to better accomplish its goal of more effectively identifying those lending relationships that may impair an auditor's independence. We set forth our views in two sections. The first section discusses the analysis that audit firms should undertake when evaluating lending relationships.<sup>4</sup> The second section provides additional comments on the impact of the Loan Provision on an investment

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<sup>4</sup> For purposes of this letter, unless otherwise stated, references to an audit firm's responsibility to monitor auditor independence also refer to an audit client fund's responsibility to monitor independence. In this regard, the SEC staff has noted that "compliance with the auditor independence rules is a shared responsibility of both the accounting firm and the [audit client] company and its audit committee." See Michael W. Husich, Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 9, 2015), *available at* <https://www.sec.gov/news/speech/husich-remarks-2015-aicpa-conference-sec-pcaob-developments.html>.

company complex when the auditor is impaired with respect to one entity in the complex, as well as the lending relationships that the Loan Provision should be concerned with.

Our comments and recommendations, which we describe fully below, include the following:

Analysis of Lending Relationships

- *Eliminate Record Owners from the Scope of the Loan Provision.* As proposed, the Commission should eliminate from the Loan Provision record owners who have no economic incentive to affect the audit.
- *Substitute “Significant Influence” for the 10 Percent Bright-Line Test and Maintain the Concept of “Portfolio Management Processes.”* As proposed, the Commission should utilize a qualitative “significant influence” test that evaluates all facts and circumstances when identifying lending relationships that may impair an auditor’s independence. It should retain the concept of “portfolio management processes” to assess whether a lender (that also is a beneficial owner of the fund’s equity securities) has the ability to exercise significant influence over an audit client fund and its financial and operating policies.<sup>5</sup> The Commission should reiterate guidance regarding “portfolio management processes” in any adopting release to confirm these positions.
- *Incorporate a Materiality Assessment.* The Commission should incorporate a materiality assessment into the lending relationship analysis to appropriately reduce the scenarios that would require further examination. If a lending relationship is not material to the audit firm or any “covered person,” there is no threat to the auditor’s independence and the Commission should not require any further analysis of the lending relationship.<sup>6</sup>
- *Provide Additional Guidance on the “Significant Influence” Test.* The Commission should clarify certain aspects of beneficial ownership:
  - The Commission should clarify and narrow “beneficial owner” for purposes of the Loan Provision. In so doing, the Commission should exclude shareholders with no economic interest in the audit client, so that the analysis of lending relationships is focused on shareholders that have an economic incentive to influence the fund.

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<sup>5</sup> For purposes of this letter, references to a lender beneficially owning a fund’s equity securities include instances in which the lender directly or indirectly (through an affiliated entity) owns fund shares.

<sup>6</sup> A “covered person” is defined in Rule 2-01(f)(11) of Regulation S-X. The Loan Provision covers “immediate family members” of certain covered persons. See Rule 2-01(c)(1)(ii) of Regulation S-X. For purposes of this letter, references to “covered persons” includes their immediate family members as applicable.

- The Commission should change the proposed “known through reasonable inquiry” standard to a “known” standard when determining beneficial ownership to alleviate interpretive uncertainty around what constitutes a “reasonable inquiry;”
- The Commission should provide additional guidance on what it means to have “significant influence” in the context of certain registered funds with unique characteristics (closed-end funds and ETFs); and
- The Commission should provide additional guidance on how audit firms can meet their requirement to monitor the Loan Provision on an ongoing basis to eliminate unnecessary and costly beneficial ownership reviews.
  - The Commission affirmatively should confirm that an audit firm need not monitor beneficial ownership if it initially determines that, based on its portfolio management processes, the audit client cannot be subject to significant influence and periodically determines that there are no changes to the fund’s governance structure and governing documents.
  - The Commission should clarify that audit firms reviewing beneficial ownership changes need to focus only on information from publicly available documents.

#### Additional Comments

- *Narrow the Scope of “Audit Client.”* The Commission should further narrow the term “audit client” to exclude all pooled investment vehicles related to, and affiliates of, an audit client fund to reduce the impact that the impairment has on other attenuated entities in the investment company complex.
- *Narrow the Scope of Lending Relationships.* The Commission should limit the scope of lending relationships to those entities that can affect an audit (*i.e.*, those entities that own the fund shares or control the owner of the fund’s shares), consistent with SEC staff no-action positions.

## **II. Analysis of Lending Relationships**

### *A. Eliminate Record Owners from the Scope of the Loan Provision*

The proposed amendments eliminate record owners of the audit client’s equity securities from the scope of the Loan Provision. This approach focuses only on beneficial owners to more effectively

identify shareholders “having a special and influential role with the issuer” and therefore better captures those lending relationships that may impair an auditor’s independence.<sup>7</sup>

We commend this approach. Fund shares often are registered in the name of the financial intermediaries that distribute them. These intermediaries perform a recordkeeping function on behalf of a fund by maintaining shareholder account activity and are record owners of fund shares for the benefit of their clients. Further, these intermediaries have no economic incentive to influence the fund or the audit of the fund’s financial statements and therefore should not be included in the required analysis of lending relationships.

*B. Substitute “Significant Influence” for 10 Percent Bright-line Test and Maintain Concept of “Portfolio Management Processes”*

The proposed amendments substitute the concept of “significant influence” for the existing more than 10 percent bright-line test. While not specifically defined in the rule, the Proposing Release indicates that the Commission will look to the concept of “significant influence” as described in ASC Topic 323, *Investments—Equity Method and Joint Ventures* (“ASC Topic 323”) for this determination.<sup>8</sup> Thus, the proposed amendments establish a rebuttable presumption that a lender beneficially owning 20 percent or more of an audit client’s voting securities is presumed to have the ability to exercise significant influence, absent evidence to the contrary. ASC Topic 323 also describes several factors, any of which could indicate significant influence.<sup>9</sup>

The Proposing Release then adds that, in the fund context, the operating and financial policies relevant to the significant influence test include the fund’s investment policies and day-to-day portfolio management processes, including those governing the selection, purchase and sale, and valuation of investments, and the distribution of income and capital gains (collectively “portfolio management processes”). In addition, an audit firm can analyze whether a lender (that also is beneficial owner of the

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<sup>7</sup> See Proposing Release at text surrounding note 40.

<sup>8</sup> See ASC Topic 323.

<sup>9</sup> Under ASC Topic 323, the ability to exercise significant influence over the operating or financial policies of an audit client would be based on the facts and circumstances, and could 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; or
- Technological dependency.

See ASC Topic 323; Proposing Release at text surrounding note 54.

audit client's equity securities) has the ability to exercise significant influence over the fund's portfolio management processes based on an initial evaluation of the fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements.<sup>10</sup>

We strongly support the use of a qualitative "significant influence" test that focuses on the totality of the facts and circumstances to better identify lending relationships that legitimately could impair an auditor's independence. We also strongly support the concept of "portfolio management processes" as a means to assess whether a lender (that is also a beneficial owner of the audit client's equity securities) has the ability to exercise significant influence over an audit client fund and its financial and operating policies. We believe the proposed portfolio management processes analysis is more effective than the existing 10 percent bright-line test in identifying lenders (that are also beneficial owners) that represent a threat to the auditor's independence. Generally speaking, shareholders of funds registered under the Investment Company Act of 1940 ("Investment Company Act") should not have the ability to affect portfolio management processes, as the fund's investment adviser performs those functions exclusively (with oversight from the fund's board of directors). Accordingly, the resulting analysis appropriately limits the lending relationships in question to those that represent a legitimate threat to the auditor's independence.

Likewise, we strongly support the statements included in the Proposing Release indicating that "where the terms of the advisory agreement grant the adviser significant discretion with respect to the fund's portfolio management process and the shareholder does not have the ability to influence portfolio management processes, significant influence generally would not exist" and "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 alone should not lead to the determination that a shareholder has significant influence."<sup>11</sup>

We also support reliance on ASC Topic 323 as a means to assess whether the lender has significant influence over the fund. We believe that, for funds, the required analysis of lending relationships would consider ASC Topic 323 only after a determination that the lender can affect the fund's portfolio management processes. That is, the analysis of lending relationships would first consider whether significant influence exists based on shareholders' ability to affect the fund's portfolio management processes. If, based on that analysis, significant influence does not exist, the analysis would stop and there would be no need to consider ASC Topic 323.

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<sup>10</sup> See Proposing Release at text surrounding note 59.

<sup>11</sup> See Proposing Release at text surrounding note 60.

*C. Incorporate a Materiality Assessment*

The Proposing Release requests comment on whether the Loan Provision should include a materiality qualifier as part of the proposed significant influence test. While the Loan Provision and proposed amendments currently do not include a materiality qualifier, other elements of the Commission's auditor independence rule do. For example, the rule provides that an auditor is not independent if the accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any *material* indirect investment in an audit client.<sup>12</sup>

We similarly recommend that the Commission include, as a second step in the analysis of lending relationships, consideration of whether the loan amount is material to the audit firm, and, if not, whether the loan amount is material to any of the audit firm's covered persons. In the fund context, the materiality assessment would be performed only after the analysis of the fund's portfolio management processes results in a determination that the fund may be subject to significant influence.

If the materiality assessment is required and the loan amount is not material to the audit firm, then we believe any attempt to influence the auditor would be unsuccessful. Stated differently, the auditor could reject any attempt to influence the audit because the loan amount is immaterial to the audit firm. We believe the auditor should assess the materiality of the loan amount to the audit firm based on the audit firm's capital structure.<sup>13</sup> That assessment could be made available to the Public Company Accounting Oversight Board as part of its inspection of registered firms.

If the loan amount is not material to the audit firm, the audit firm next would determine whether any covered person of the auditor has a material loan from the beneficial owner of the fund's shares. If a loan amount also is not material to any covered person, then it would be unlikely for a lender to be able to exert influence over the auditor or covered person through the lending relationship. If the loan amount is neither material to the audit firm nor any covered person, then significant influence would not exist (notwithstanding any determination that significant influence may exist based on the fund's portfolio management processes), and no further analysis would be required.

Even if the Commission does not see fit to incorporate a materiality assessment in the analysis of lending relationships, we recommend that it expand the exclusion for fully collateralized loans made under the lender's normal procedures, terms and requirements.<sup>14</sup> Specifically, we recommend that the Commission expand the exclusion to include *all* fully collateralized loans regardless of the timing of when the loan was made. Collateralized loans already are fully backed by their underlying assets. In

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<sup>12</sup> See Rule 2-01(c)(1)(i)(D) of Regulation S-X (emphasis added).

<sup>13</sup> We believe that an audit firm could make this assessment without the assistance of its audit client.

<sup>14</sup> See Rule 2-01(c)(1)(ii)(A)(1) through (4) of Regulation S-X. See also Proposed Rule 2-01(c)(1)(ii)(A)(1)(i) through (iv) of Regulation S-X.

addition, there is no rationale for treating unspecified collateralized loans differently than the ones specified in the Loan Provision. Further, we recommend that the Commission exclude loans that are *de minimis* to a covered person (e.g., mobile phone financing arrangements) from this analysis as they are unlikely to impair a covered person or an audit firm's objectivity and impartiality.<sup>15</sup>

*D. Provide Additional Guidance on the "Significant Influence" Test*

As noted above, we believe that an audit firm would first analyze whether significant influence over an audit client fund's portfolio management processes could exist based on an initial evaluation of the fund's governance structure and governing documents. As a next step, we recommend a materiality assessment in order to eliminate violations that are not true threats to independence. In those instances, the equity owner cannot influence the audit (as determined through the fund's portfolio management processes) or because the amount of the loan is not material to the audit firm or its covered persons. After substantially reducing the number of these "false positives," audit firms then, if necessary, could undertake the lengthy and costly analysis of determining the equity owners that could and do have significant influence over the audit client's operating and financial policies.

In this regard, we agree with the SEC's approach of using qualitative measures to determine significant influence but recommend that the Commission provide additional guidance on the scope of the entities and situations that it is concerned about. In particular, we recommend that the Commission:

- Clarify and narrow "beneficial owner" for purposes of the Loan Provision to exclude certain owners with no economic interest in the audit client;
- Change the "known through reasonable inquiry" standard to a "known" standard when determining beneficial ownership;
- Provide additional guidance on what it means to have "significant influence" in the context of closed-end funds and ETFs; and
- Provide additional guidance on how audit firms can meet their requirement to monitor the Loan Provision on an ongoing basis after their initial evaluation.

1. Beneficial Ownership

a. Clarify and Narrow "Beneficial Owners" for Purposes of the Loan Provision

The proposed amendments would rely on the principles set forth in ASC Topic 323 to determine whether an equity owner has significant influence over an audit client's operating and financial

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<sup>15</sup> In this regard, we note that current Rule 2-01(c)(ii)(E) of Regulation S-X provides that an accountant is not independent if it owes a lender a credit card balance of more than \$10,000. We suggest the Commission specify that loan balances under \$10,000 are *de minimis*.



policies.<sup>16</sup> ASC Topic 323 establishes a rebuttable presumption that a lender beneficially owning 20 percent or more of an audit client's voting securities is presumed to have the ability to exercise significant influence over the audit client, absent predominant evidence to the contrary.<sup>17</sup> "Beneficial owner" is not defined specifically for purposes of the Loan Provision. Under the securities laws, however, "beneficial owner" is defined in various ways. For example, a "beneficial owner" is defined as any person who, directly or indirectly, has (i) voting power which includes the power to vote or direct the voting of, such security; and/or (ii) investment power which includes the power to dispose, or to direct the disposition, of such security.<sup>18</sup> A "beneficial owner" also is defined as any person who has or shares direct or indirect pecuniary interest in equity shares, where "pecuniary interest" is further defined to mean to have the opportunity, directly or indirectly, to profit in a transaction in the shares.<sup>19</sup>

We appreciate the proposed use of the already-existing standards set forth in ASC Topic 323 to guide an audit firm's evaluation, but we believe that the concept of "beneficial owner" in the Loan Provision context must be clarified and narrowed to avoid capturing entities that the proposed amendments clearly are trying to exclude. The "beneficial owner" standards set forth under the securities laws would require audit firms to assess all owners that have the right to vote or dispose of shares. Employing these standards unintentionally may capture financial intermediaries that own shares on a "record basis" – one group that the Proposing Release specifically tries to exclude.<sup>20</sup> For example, under New York Stock Exchange ("NYSE") Rule 452, financial intermediaries that are record owners may vote on behalf of their clients when no voting instructions are received within 10 days of the annual meeting and the matters are "routine," generally uncontested and do not include a merger, consolidation, or any matter that may affect substantially the rights or privileges of such stock.<sup>21</sup> In those situations, the proposed amendments would treat those financial intermediaries that are record owners with no economic interest in the audit client as "beneficial owners" because they have the right to vote those shares. As beneficial owners, audit firms must then determine whether those record owners have significant influence under ASC Topic 323.

As the Proposing Release points out, however, beneficial owners that do not have any economic interest in an audit client do not benefit directly from the performance of securities of which they are record owners and have little incentive to attempt to influence a fund or an audit firm's report.<sup>22</sup> Accordingly,

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<sup>16</sup> See ASC Topic 323.

<sup>17</sup> See Proposing Release at note 56.

<sup>18</sup> See Rules 13d-3 and 16a-1(a)(1) under the Securities Exchange Act of 1934 ("Exchange Act").

<sup>19</sup> See Rule 16a-1(a)(2) under the Exchange Act.

<sup>20</sup> See Proposed Rule 2-01(c)(1)(ii)(A)(1) of Regulation S-X (eliminating record ownership from the scope of the Loan Provision). See also Proposing Release at nn. 38-40 and surrounding text.

<sup>21</sup> See NYSE Rule 452. See also Proposing Release at note 38.

<sup>22</sup> See, e.g., Proposing Release at note 38 and surrounding text.

the Commission should clarify that the scope of the Loan Provision excludes *all* beneficial owners with no economic interest in the audit client, including those that can vote an audit client's shares nominally. Excluding these beneficial owners from the analysis would save audit firms, funds, and investment advisers, the time and expense associated with determining whether these owners in name only have significant influence over an audit client's operating and financial policies.

b. Change the "Known Through Reasonable Inquiry" Standard to a "Known" Standard When Determining Beneficial Ownership

The Commission proposes to add a "known through reasonable inquiry" standard to address concerns about an audit firm's ability to access records or other information about beneficial owners. The Commission rationalizes that, "if an auditor does not know after reasonable inquiry that one of its lenders also is a beneficial owner of the audit client's equity securities . . . then the auditor is unlikely to be impacted by its debtor-creditor relationship with the lender." It also notes that the "known through reasonable inquiry" is a concept that should be familiar to those charged with compliance with the Loan Provision and cites certain regulations and form requirements in which the standard or a "known" standard is applied.<sup>23</sup>

We support the addition of a "knowledge" standard to the beneficial ownership analysis and the Commission's acknowledgement of the practical difficulties that audit firms have in attaining beneficial ownership information through no fault of their own. Financial intermediaries are prohibited from disclosing to an issuer the identity of beneficial owners who object to disclosures of their name, address, and securities positions ("objecting beneficial owners"), so audit firms often are unable to obtain complete beneficial ownership information.<sup>24</sup> In many cases, when financial institutions do provide information about beneficial owners, it is only with respect to those beneficial owners who affirmatively consent to them providing such information.<sup>25</sup> Further, even if financial intermediaries do provide the

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<sup>23</sup> See Proposing Release at note 64 and surrounding text.

<sup>24</sup> See Rule 14a-13(b) under the Securities Exchange Act of 1934 (permitting issuers to obtain from broker-dealers and banks a list of names, addresses, and securities of only the beneficial owners who either have consented or have not objected to having such information provided to issuers). See also Proposing Release at note 63; Rules 14b-1 and 14b-2 under the Securities Exchange Act of 1934 (setting forth requirements for broker-dealers and banks to provide beneficial ownership information). As of 2006, we understand that over 75 percent of customers holding shares in financial intermediary accounts are objecting beneficial owners. See Alan L. Beller and Janet L. Fisher, *The OBO/NOBO Distinction in Beneficial Ownership: Implications for Shareowner Communications and Voting* (2010) at note 12, available at <https://www.sec.gov/comments/s7-14-10/s71410-22.pdf> (citing Report and Recommendations of the Proxy Working Group to the New York Stock Exchange 11 (2006)).

<sup>25</sup> We understand that some financial intermediaries default beneficial owners who do not affirmatively consent to providing such information to issuers to being deemed "objecting beneficial owners." As a result, these financial intermediaries only provide information about beneficial owners that affirmatively have consented to providing the information.

information, financial intermediaries may not know that a beneficial owner has breached a particular ownership threshold until after the fact because they do not control the activity of the underlying beneficial owners. Thus, we agree that a knowledge standard is a critical step toward resolving the practical difficulties that audit firms have in identifying beneficial owners.

The use of a “known through reasonable inquiry” standard, however, raises questions as to what “reasonable inquiry” means. Certain financial intermediaries may not have a regulatory or contractual obligation to provide any information about their beneficial owners. Thus, one could ask whether it is sufficient for an audit firm that asks for that information to stop their inquiry once the intermediary refuses to provide the requested information. Regardless of the nature or reasonableness of an inquiry or whether an audit firm even has made an inquiry, an audit firm that does not know that a lender is a beneficial owner is unlikely to be impacted by any debtor-creditor relationship with that lender.<sup>26</sup> In those circumstances, a lender that is not known to have beneficial ownership of a fund has little or no ability to affect the results of the audit.

As the Commission demonstrates in the Proposing Release, registered funds also currently employ a “known” standard, not a “known through reasonable inquiry” standard, to disclose beneficial ownership information in their filings. Form N-1A requires registered open-end funds to disclose the name of each person who is *known* by the fund (not “known through reasonable inquiry”) to own beneficially 5 percent or more of any class of the fund’s outstanding equity securities.<sup>27</sup> Form N-2 likewise requires closed-end funds to disclose each person *known* by the fund (not “known through reasonable inquiry”) to own beneficially 5 percent or more of any class of the fund’s outstanding equity securities.<sup>28</sup> The adopting release should clarify that audit firms only need to look to the audit client’s public documents to gather beneficial ownership information, such as a fund’s proxy materials, a fund’s Statement of Additional Information, or Schedule 13Ds or 13Gs for closed-end funds.<sup>29</sup> Moving from a “known through reasonable inquiry” standard to a “known” standard would enable audit firms to leverage existing reporting practices to identify beneficial owners, while also meeting the Commission’s stated rationale for recommending the “known through reasonable inquiry” standard.

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<sup>26</sup> To ensure that audit firms do not willfully ignore information, the Commission could issue guidance that an audit firm has “constructive knowledge” of ownership when such information is publicly disclosed in the SEC-required filings related to the audit client.

<sup>27</sup> See Item 18 of Form N-1A (emphasis added).

<sup>28</sup> See Item 19 of Form N-2 (emphasis added).

<sup>29</sup> Although registered funds disclose 5 percent beneficial owners on a class basis in their Statements of Additional Information, audit firms and funds could leverage these systems to aggregate information on a fund-level basis.

## 2. “Significant Influence”

### a. Provide Additional Guidance on “Significant Influence” for Specific Types of Funds

As with other types of registered funds, we believe that the portfolio management processes evaluation and materiality assessment should reduce appropriately the number of closed-end funds and ETFs that audit firms must evaluate. For the remaining closed-end funds and ETFs, we believe that the Commission should provide more guidance on what it means to have “significant influence” given their unique characteristics.

#### i. Closed-End Funds

Closed-end funds differ from other types of funds as they can issue preferred stock as well as common stock.<sup>30</sup> Preferred stock holders have special rights in addition to voting rights they share with common stock holders on matters of joint interest.<sup>31</sup> For example, preferred stock holders are entitled, as a class, to elect at least two directors of the fund’s board of directors at all times and to elect a majority of the board of directors at any time two full years’ of preferred stock dividends are unpaid until all dividends in arrears are paid.<sup>32</sup> In addition, preferred stock holders, as a class, must approve any reorganization adversely affecting the preferred stock or on any proposal solely affecting that class of stock.<sup>33</sup> At times, lenders to audit firms may invest in and hold a sizeable portion, including up to 100 percent, of a closed-end fund’s class of preferred stock. With such ownership positions that confer unique rights, questions could arise as to whether the lender/closed-end fund preferred stock holder *per se* has “significant influence” over the fund.

Under the Commission’s approach to “significant influence,” we believe the ability of a large shareholder to elect two directors should not necessarily lead to the conclusion that preferred stock holders can affect the closed-end fund’s portfolio management processes. As drafted, the proposed amendments appropriately view significant influence from the audit client level (*i.e.*, fund) and not at

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<sup>30</sup> See Section 18(f)(2) of the Investment Company Act.

<sup>31</sup> In addition, preferred stock offerings through restrictions in a fund’s governing documents (e.g., by-laws) or otherwise may restrict a fund’s investment strategy indirectly (e.g., imposing limitations on a fund’s ability to engage in leverage or invest in high yield bonds). These restrictions are intended to protect preferred stock holders’ dividend payments and ensure priority payments on eventual redemptions.

<sup>32</sup> See Section 18(f)(2)(C) of the Investment Company Act. Often one board oversees all of the funds in the complex, both open-end and closed-end. In many instances, the disinterested directors are responsible for the selection and nomination of disinterested director candidates to fill board vacancies. While preferred stock holders voting as a class are entitled to elect two directors, the fact that their selection and nomination is committed to the disinterested directors should ameliorate concerns that a lender/large preferred stock holder could affect the closed-end fund’s portfolio management processes.

<sup>33</sup> See Section 18(f)(2)(D) of the Investment Company Act.

each class of the audit client.<sup>34</sup> In the case of a closed-end fund, the audit client should be viewed as the entire closed-end fund and the preferred shares as only a portion of the equity securities of the audit client.<sup>35</sup> Thus, even though a shareholder that owns a large percentage of outstanding preferred stock might be able to more significantly influence the fund on initiatives related to the preferred stock, the preferred stock holder generally cannot influence the outcome of any vote regarding the overall fund. In addition, although preferred stock holders are entitled at all times to elect two directors of the fund's board, a shareholder that owns a large percentage of preferred stock should not necessarily be deemed to carry "significant influence," unless the two directors constitute the majority of the fund's board.<sup>36</sup> Two directors that do not have the ability to unilaterally approve any measures cannot themselves change a fund's operating or financial policies. Accordingly, a lender shareholder that owns a large percentage of preferred stock that confers the ability to elect two directors should not *per se* lead to a conclusion that the lender shareholder has "significant influence."<sup>37</sup>

## ii. Exchange-Traded Funds

Pursuant to Commission exemptive relief, only certain large ETF shareholders ("authorized participants") can transact directly with the ETF and only in large units called creation units, consisting of several thousand ETF shares (*e.g.*, 25,000 or 50,000). In some cases, only two to four creation units comprise an ETF's entire volume of outstanding shares, so each creation unit may constitute a substantial portion of the ETF's outstanding shares. While authorized participants may occasionally deal in the creation units for their own account (or for their affiliate's accounts), the vast majority of authorized participant transactions are conducted on behalf of third parties. With most transactions occurring on behalf of others without any economic interest from an authorized participant, we agree and applaud the Commission for stating that "the deposit or receipt of basket assets by an [authorized participant] that is also a lender to the auditor alone would not constitute significant influence over an ETF audit client."<sup>38</sup> To provide additional clarity in this area, we recommend that the Commission reiterate this helpful statement in any adopting release.

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<sup>34</sup> See Proposed Rule 2-01(c)(1)(ii)(A)(1) of Regulation S-X (the Loan Provision covers "[a]ny 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 equity securities* . . .") (emphasis added).

<sup>35</sup> We further note the Commission's statements that "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 alone generally should not lead to the determination that a shareholder has significant influence." See Proposing Release at text surrounding note 60.

<sup>36</sup> This also could occur if the closed-end fund has not paid two full years' of preferred stock dividends until all dividends in arrears are paid. See *supra* note 32.

<sup>37</sup> Cf. ASC Topic 323 (the ability to exercise significant influence over the operating and financial policies of an audit client would be based on the facts and circumstances and could be indicated by representation on the board of directors). See *also* Proposing Release at note 54 and surrounding text.

<sup>38</sup> See Proposing Release at Section III. Request for Comment – "Significant Influence" Test.

b. Exclude Owners that Waive their Ability to Exercise Voting Rights

We understand that, in several instances, owners of fund shares may take steps to limit their discretion to vote those shares. For example, a closed-end fund's preferred stock holders may create an irrevocable voting trust to vote the shares without the owner's discretion, an ETF authorized participant might relinquish its right to vote its shares, or an insurance company separate account may agree to "mirror vote" its shares (*i.e.*, vote the shares held in the same proportion as the vote of all other shareholders or vote in accordance with determinations made under arrangements with a third-party proxy provider). In each of these situations, the owner has relinquished its control to vote its shares and its ability to exercise "significant influence" over the fund, including over the fund's operating and financial policies. Without the power to vote, the lender/shareholder has no ability to use voting power to influence the audit or the audit firm. We therefore believe that the Commission should affirm that no significant influence exists or that the rebuttable presumption in ASC Topic 323 is overcome when a lender/shareholder relinquishes its ability to exercise its voting rights over a fund's shares.

c. Provide Further Guidance on "Ongoing Monitoring"

The Proposing Release states that, "[i]f the auditor determines that significant influence does not exist based on the facts and circumstances at the time of the auditor's initial evaluation, [the Commission believes] that the auditor should monitor the Loan Provision on an ongoing basis . . ." <sup>39</sup> The Proposing Release further adds that an audit firm could do this "by reevaluating its determination in response to a material change in the fund's governance structure and governing documents, publicly available information about beneficial owners, or other information which may implicate the ability of a beneficial owner to exert significant influence of which the audit client or auditor becomes aware." <sup>40</sup>

We agree that, after an audit firm determines there is no significant influence, it could conduct periodic monitoring, which would consist of monitoring changes to the governance structure and governing documents as well as other information that could implicate the ability of a beneficial owner to exert significant influence. We recommend, however, that the Commission clarify two items within these statements.

First, we recommend that the Commission confirm that an audit firm does not need to monitor ownership holdings if it initially determines that, based on its portfolio management processes, the audit client cannot be subject to significant influence and determines that there are no changes to the fund's governance structure and governing documents. Under those circumstances, if there are no changes to the governance structure or governing documents, then the initial determination that there can be no significant influence over the fund remains unchanged. Thus, it is unnecessary for the audit

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<sup>39</sup> See Proposing Release at text surrounding note 60.

<sup>40</sup> See Proposing Release at text surrounding note 72.

firm to engage in any costly beneficial ownership determinations until it is deemed necessary due to a change to the governance structure or governing documents.

Second, we recommend that the Commission clarify that audit firms that must look at beneficial ownership changes need to focus only on information from publicly available documents. Focusing attention on public documents (*i.e.*, those relevant documents that are filed with the SEC) appropriately narrows the beneficial ownership analysis to entities that the audit firm knows about. For open-end funds, audit firms and funds could look at a fund's beneficial ownership disclosures provided in its Statement of Additional Information. For closed-end funds, an audit firm could look at a beneficial owner's Schedule 13D or 13G filings that are made under a fund's SEC file number. If the audit firm does not know about a lender's ownership position and does not have constructive knowledge of the lender's ownership through public filings, then the lender would have no ability or incentive to influence the results of the audit.

### **III. Additional Recommendations**

In addition to our comments on conducting the lending relationship analysis, we recommend that the Commission reduce the broad applicability of the Loan Provision by narrowing the scope of the term "audit client" and narrowing the scope of the "lending relationships" to effectively capture only those relationships that raise independence concerns.

#### *A. Narrow the Scope of "Audit Client"*

Currently, under the auditor independence rules, the term "audit client" is defined to include any affiliate of the entity whose financial statements are being audited. "Affiliates of the audit client" include other entities that control, are controlled by, or are under common control with the audit client. Accordingly, an auditor is not independent of an entity in the investment company complex if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of the equity securities of either i) the audit client, or ii) any entity that is a controlling parent company of the audit client, a controlled subsidiary of the audit client, or any entity under common control with the audit client. In addition, "affiliate of the audit client" includes each entity in an investment company complex of which the audit client is a part. As a result, the auditor is not independent of an entity in the investment company complex if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of any entity in the investment company complex.

This expansive definition of "audit client" may cause a broad range of entities beyond the audit client fund to violate the Loan Provision. The Proposing Release indicates that the inclusion of certain entities in the investment company complex as a result of the far-reaching definition of audit client is in tension with the Commission's original goal of facilitating compliance with the Loan Provision without decreasing its effectiveness. Accordingly, the Commission proposes to, for purposes of the Loan

Provision, exclude from the definition of “audit client” a fund that otherwise would be considered an “affiliate of the audit client.” The proposed amendments would define the term “fund” for this purpose to include an investment company or an entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act.

1. Exclude from “Audit Client” Other Pooled Investment Vehicles that May Be Considered Affiliates

We agree that the expansive “audit client” definition is in tension with the intent and effectiveness of the Loan Provision. We also strongly support the proposed amendments to appropriately exclude “funds” in the investment company complex (other than the fund under audit). Even in the unlikely scenario that a lender to the auditor could exert significant influence over the fund under audit, the lender likely would not have the ability to influence the other funds in the complex and therefore the auditor should retain its independence as to those other funds.

We urge the Commission to similarly recognize that the auditor should retain its independence as to other pooled investment vehicles in the complex. Certain investment advisers manage pooled investment vehicles that are not investment companies and do not rely on the exclusions provided by Section 3(c) of the Investment Company Act. Such products may include, for example, commodity pools registered under the Securities Act of 1933 and the Securities Exchange Act of 1934. We are concerned that such pooled products could be deemed to be an “affiliate of the audit client” of the fund under audit, notwithstanding the proposed amendments. In particular, when an auditor loses its independence as to an audit client fund due to noncompliance with the Loan Provision, it also would lose its independence as to the pooled investment vehicle.

There has been some debate over the years as to whether a pooled investment vehicle organized and offered outside of the US would be relying on an exemption under Section 3(c) of the Investment Company Act. We are concerned that these pooled products also could be deemed to be an “affiliate of the audit client” of the fund under audit, notwithstanding the proposed amendments. For the same reasons that the Commission proposes the exclusion for “funds,” the Commission should exclude commodity pools and investment pools organized and offered outside the US (that would be an investment company if organized under the laws of a state or territory of the US) from the definition of “audit client.”

2. Exclude from “Audit Client” the Fund’s Investment Adviser and Other Entities in the Investment Company Complex

While we support the proposed amendments to the “audit client” definition, we believe the Commission can further expand the excluded entities to cover more than just “funds.” When the Commission first proposed the Loan Provision, it noted that a debtor-creditor relationship between an auditor and its audit client could be viewed as creating a self-interest that competes with the auditor’s



obligation to serve only investors' interests.<sup>41</sup> That concern was intended to extend beyond loans directly between the auditor and its audit client to those shareholders who have a "special and influential role with the audit client" evidenced through record or beneficial ownership of more than 10 percent of the audit client's equity securities.

Where the lender to the auditor can exercise significant influence over the audit client fund, we do not believe it follows that the lender has a special and influential role with the fund's investment adviser or that the lender can exercise significant influence over the fund's investment adviser. For this reason, we recommend that the Commission, for purposes of the Loan Provision, exclude from the definition of "audit client" the fund's investment adviser (including any parent that controls the investment adviser) that otherwise would be considered an affiliate of the audit client. This change would allow the auditor to the fund that has lost its independence due to noncompliance with the Loan Provision to nevertheless retain its independence as to the fund's investment adviser (and any parent entity).

We further recommend that the Commission, for purposes of the Loan Provision, exclude from the definition of audit client other investment advisers in the investment company complex that do not serve as investment adviser to the audit client fund (including any parent of those investment advisers) as well as other service providers in the investment company complex (*i.e.*, any entity engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company or investment adviser). These service providers' connection to the audit client fund are even more attenuated than the connection to the investment adviser of the audit client fund, and the fund shareholder is unlikely to influence the results of their audits.

#### *B. Narrow the Scope of Lending Relationships to be Analyzed*

In the Fidelity Letter, the SEC staff stated that it would not recommend enforcement action to the Commission, even though certain entities identified in the letter used audit firms that did not comply with the Loan Provision, subject to certain conditions specified in the letter.<sup>42</sup> In providing relief, the staff indicated that the relevant lending institutions to be analyzed under the Loan Provision are the fund's shareholders and those entities that "control" the fund's shareholders (*i.e.*, the Loan Rule does not cover lending relationships between an auditor and entities that are under common control with or controlled by the shareholder). The Proposing Release reiterates the statement in the Fidelity Letter stating that the Loan Provision does not cover lending relationships between an auditor and entities that are under common control with or controlled by the shareholder.<sup>43</sup> We agree with this position

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<sup>41</sup> See *Revision of the Commission's Auditor Independence Requirements*, SEC Release No. 33-7870 (June 30, 2000) (proposing release), available at <https://www.sec.gov/rules/proposed/34-42994.htm>.

<sup>42</sup> See Fidelity Management & Research Company (pub. avail. June 20, 2016) ("Fidelity Letter"), available at <https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm>.

<sup>43</sup> See Proposing Release at note 22.

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Securities and Exchange Commission  
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and we recommend that the Commission include in any adopting release a similar statement indicating that the lending relationships to be analyzed are those between the auditor and the beneficial owner or those that control the beneficial owner, and that entities that are under common control with or controlled by the beneficial owner are not implicated by the Loan Provision.

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We appreciate the opportunity to comment on the proposed amendments. If you have any questions regarding our comment letter or would like additional information, please feel free to contact Ken Fang at (202) 371-5430 or [kenneth.fang@ici.org](mailto:kenneth.fang@ici.org), Lisa Hamman at (202) 371-5405 or [lhamman@ici.org](mailto:lhamman@ici.org), or Greg Smith at (202) 326-5851 or [smith@ici.org](mailto:smith@ici.org).



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