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SEC Adopts Amendments to Auditor Independence Rule

By The Investment Management Practice

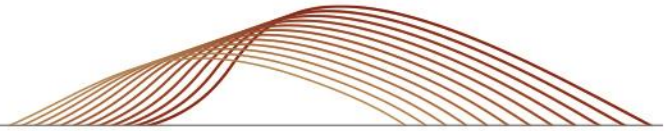
Introduction

On June 18, 2019, the Securities and Exchange Commission (the "SEC" or the "Commission") adopted amendments to the auditor independence rules to "refocus the analysis" that must be done in order to conclude that an auditor is independent when such auditor "has a lending relationship with certain shareholders of an audit client at any time during an audit or professional engagement period." In the adopting release ("Adopting Release"), the Commission noted that the amendments (1) focus the analysis on beneficial ownership rather than on both record and beneficial ownership; (2) replace the existing ten percent bright-line shareholder ownership test with a significant influence test; (3) add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and (4) 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 under the rules for certain lending relationships.

I. Background

Rule 2-01 of Regulation S-X requires auditors to be independent of their audit clients both "in fact and in appearance," capable of "exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."[1] Rule 2-01(c), which the Commission provides a nonexclusive list of circumstances considered by the SEC to be "inconsistent with the independence," including certain financial relationships. Under Rule 2-01(c)(1)(ii)(A) ("Loan Provision"), an accountant is deemed not independent when (a) the accounting firm, (b) any covered person[2] in the firm (i.e., partners, principals, shareholders and employees of an accounting firm, such as the audit engagement team and those in the chain of command), or (c) any of his or her 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.[3]

The bright-line 10% test means that an accounting firm 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 percent of the equity securities of either (a) the firm's audit client; or (b) any entity that is a controlling parent company of the audit client, a controlled subsidiary of the audit client, or an entity under common control with the audit client,"[4] or if it has a lending relationship with an entity having a record or beneficial ownership of more than 10% of any entity within an investment company complex, regardless of which entities in the investment company complex ("ICC") are audited by the accounting firm.



The staff of the SEC's Division of Investment Management first addressed the "loan rule" issue in 2016, when the Fidelity Management & Research Company requested no-action relief[5] if a Fidelity entity used the audit services performed by a public accounting firm where the audit firm has a relationship that would cause technical non-compliance with the Loan Provision so long as: (1) the Audit Firm has complied with Rule 3526(b)(1) and (2) of the Public Company Accounting Oversight Board ("PCAOB"), (2) the non-compliance of the audit firm is regarding specific lending and ownership relationships, and (3) the audit firm has concluded that notwithstanding its technical noncompliance, it remains objective and impartial with respect to the issues covered under the audit relationship. Based on the circumstances outlined in the no-action relief, the staff of the Division of Investment Management agreed to grant Fidelity time-limited relief.[6] In May 2018, the Commission proposed amendments to Rule 2.01 of Regulation S-X (the "Proposal"). The Proposal sought to limit application of the Rule's scope with respect to shareholders to beneficial owners of an audit client's equity securities, known through reasonable inquiry, where the owner has significant influence over the client.

II. Amendments to Auditor Independence Rule

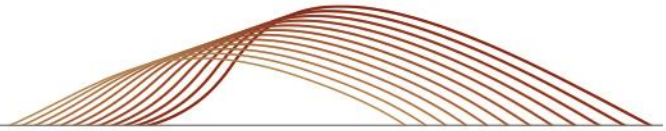
The final amendments make four amendments to the Loan Provision:

1. Focus the analysis solely on beneficial ownership. This would alleviate concerns related to record ownership. The SEC believes that tailoring the Loan Provision to focus on the beneficial ownership of the audit client's equity securities would more effectively identify shareholders "having a special and influential role with the issuer" and therefore better capture those debtor-creditor relationships that may impair an auditor's independence.

2. Replace the 10% rule with a "significant influence" test. Rather than a bright-line rule, this test would assess whether a lender has the ability to exert significant influence over an audit client's operating and financial policies, based on the totality of the facts, including board representation, participation in policy-making process, material intra-entity transactions, interchange of managerial personnel, technological dependency, as well as the level of beneficial ownership (i.e., establishing rebuttable presumptions that a lender beneficially owning at least 20% of an audit client's voting securities has the ability to exercise significant influence and that owners of less than 20% do not have significant influence, unless it could be demonstrated otherwise).

3. Add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities. Auditors would be required to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry. If an auditor does not know after reasonable inquiry that one of its lenders is also a beneficial owner of the audit client's equity securities, the auditor's objectivity and impartiality is unlikely to be impacted by its debtor-creditor relationship with the lender.

4. Amend the Loan Provision's definition of "audit client" to exclude funds that would currently be considered "affiliates of the audit client." Consistent with the proposed release, the inclusion of certain entities in the ICC as a result of the definition of "audit client" is in tension with the Commission's original goal to facilitate compliance with the Loan Provision without decreasing its effectiveness. Auditors often have little transparency into the investors of other funds in an ICC (unless they also audit those funds), and therefore, are likely to have little ability to collect such beneficial ownership information. Investors in a fund



> typically do not possess the ability to influence the policies or management of other "sister" funds and that this does not depend on whether the funds are investment companies or other types of pooled investment vehicles. The SEC noted that expanding the definition of "fund" to encompass commodity pools is consistent with its intent to exclude for a fund under audit any other funds that otherwise would be considered an affiliate of the audit client.

It is also worthwhile to note that the Final amendments differ in certain respects from the Proposal. For example, the final amendments define "fund" for these purposes to also exclude commodity pools and the SEC clarified that foreign funds[7] are excluded for purposes of the definition of audit client. The Adopting Release also notes that final amendments "may result in an expanded set of choices among existing sources of financing" for audit firms. And this may "lead to more efficient financing activities for audit firms, thus potentially lowering the cost of capital for these firms" and indirectly result in savings for funds and their shareholders, "if the savings are passed on to investors."[8] The Commission, however, acknowledged that that audit firms "likely already receive market financing terms. Therefore, this effect may not be significant in practice."[9]

III. Looking Ahead

The Adopting Release also notes that the Chairman has directed the staff to formulate recommendations to the Commission for possible additional changes to the auditor independence rules. The Chairman directive comes as a result of certain comments submitted in connection with the Proposal, specifically comments (1) relating to the Loan Provision, but not the significant compliance challenges that need to be immediately addressed (e.g., other types of loans that commenters suggested should be excluded from the Loan Provision, such as student loans); (2) relating to the "covered person" and "affiliate of the audit client" definitions; or (3) to narrow the look-back period for domestic initial public offerings so that the period is similar to that for foreign private issuers.[10]

These amendments will become effective 90 days after they are published in the Federal Register.

The SEC's press release can be found here.

The SEC's Adopted Rules can be found at the following links: Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships.

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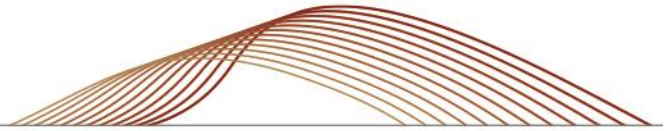

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 *See* Rule 2-01(b) of Regulation S-X.

2 *See* Rule 2-01(f)(11) of Regulation S-X (defining the term "Covered persons").

3 *See* Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships ("Adopting Release"), Release No. 33-10648, (June 18, 2019), pp. 5 available at https://www.sec.gov/rules/final/2019/33-10648.pdf.

4 *See id*. at 51.

5 See No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (June 20, 2016) ("June 20, 2016 Letter"), available at https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm.

6 *See id*. The initial relief was temporary and was set to expire 18 months from its issuance. Subsequently, the staff of Division of Investment Management extended its initial relief and noted that the permanent no-action relief would be withdrawn upon the effectiveness of any amendments to the Loan Provision.

7 The Adopting Release refers to a "foreign fund" as an "investment company" as defined in Section 3(a)(1)(A) of the Investment Company Act of 1940 that is organized outside the U.S. and that does not offer or sell its securities in the U.S. in connection with a public offering.

8 *See* Adopting Release at 61.

9 *See id*.

10 *See* Adopting Release at 48.