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Making Sense of Auditor Independence Issues

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Auditor independence has always been a regulatory compliance priority. Failure to comply with independence requirements has potentially serious legal and business consequences, including the risk that an audit engagement will be terminated and past financial statements reaudited.

Registered investment companies (funds) are subject to the same auditor independence requirements as other public companies. However, rules applicable to funds are broader and more complicated. A number of actions by the Securities and Exchange Commission (SEC) and its Staff over the last several months have focused on the complex way the independence rules apply to funds and their auditors. The actions also remind fund boards and audit committees of the importance of reviewing independence matters with fund auditors.

As widely reported, the auditor independence rules were the subject of a no-action letter granted by the SEC Staff to Fidelity Management & Research Company (Fidelity) (the Fidelity Letter) in June 2016.[1] The Fidelity Letter temporarily addresses some of the issues that have arisen under Rule 2-01(c)(1)(ii)(A) of Regulation S-X, otherwise known as the "Loan Rule." The Loan Rule provides that an audit firm is not independent if one of its lenders owns more than 10 percent of the voting securities of a fund audit client.

Although it provides important relief for funds, the Fidelity Letter left open a number of questions. Following conversations with the SEC Staff, the Investment Company Institute issued a "Frequently Asked Questions" (ICI FAQ) memorandum in September 2016 to clarify certain of these issues.[2] Also in September 2016, the SEC settled two enforcement actions regarding personal relationships that potentially compromise auditor independence.

This article analyzes the scope of the Fidelity Letter relief, the ICI FAQ guidance, and recent SEC enforcement actions. It also discusses questions and issues that fund boards and management may need to consider.

The Loan Rule and Investment Companies

Rule 2-01 of Regulation S-X requires auditors to be independent of their audit clients. The SEC will not recognize an audit firm as independent with respect to an audit client if the audit firm "is not capable of exercising objective and impartial judgment on all issues encompassed" within the audit firm's engagement.[3] The SEC has stated that this involves assessing whether a relationship "creates a mutual or conflicting interest between the audit firm and audit client."[4]

Rule 2-01 lists specific arrangements that the SEC deems inconsistent with audit firm independence. The Loan Rule is one of the listed arrangements. It states that "[a]n accountant is not independent if, at any point during the audit and professional engagement period, the accountant has

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a direct financial interest or a material indirect financial interest in the accountant's audit client. . . ."[5]

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. . . ."[6] The SEC has exempted certain types of routine loans made by lenders under normal lending procedures and requirements.

Rule 2-01 adopted a broad definition of "audit client" in the fund context. It provides that an audit client includes "[e]ach entity in the investment company complex when the audit client is an entity that is part of an investment company complex."[7] The rule defines "investment company 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.[8] The investment company complex definition could be interpreted as potentially triggering a Loan Rule violation with respect to every fund and Adviser Affiliate in a fund complex even when only one fund may have an independence issue.

The preliminary notes to Rule 2-01 state that application of the independence requirements depends on the "particular facts and circumstances."[9] This fact-based approach to applying the rule potentially allows sharply different interpretations. For example, prior to the Fidelity Letter, some audit firms reportedly had argued that mutual fund shares are not equity securities for purposes of the Loan Rule. Under that interpretation, a loan from an audit firm lender that has 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 audit firms reportedly took the position that shares held in an omnibus custodial account were not held "of record or beneficially." The Fidelity Letter, however, now makes clear that the SEC Staff views mutual fund shares and shares held in omnibus accounts as subject to the Loan Rule.

The Fidelity Letter and the ICI FAQ

Fidelity requested no-action relief after it learned that the audit firm for some of its funds had loans outstanding from financial institutions that owned 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 Fidelity funds complex continues to use the audit firm as long as certain conditions are met.

The SEC Staff emphasized the representation made by the audit firm to Fidelity that, notwithstanding its noncompliance with the Loan Rule, it was able to "maintain its impartiality and objectivity with respect to the planning for and execution of the Fidelity Funds' audits."[10] In addition, the SEC Staff noted that the audit firm had assured Fidelity that the lender was unable to impact the impartiality of, or assert any influence over, the funds or their investment adviser. The SEC Staff granted the no-action relief subject to the following conditions:

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

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"objective and impartial" with respect to all issues encompassed within its engagement.[11]

4. The audit firm's lender does not exercise discretionary voting authority with respect to at least ten percent of the fund shares.

The Fidelity Letter no-action relief expressly covers the following types of situations that audit firms have found problematic: (1) when an audit firm'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 audit firm's lender is an insurance company that holds more than 10 percent of an audit client in a separate account; and (3) when an audit firm's lender acts as an authorized participant or market maker for an exchange-traded fund (ETF) and, as such, holds more than ten percent of the shares of an ETF that is an audit client.

The Fidelity Letter provides some clarification regarding the application of the Loan Rule but did not address a number of important questions. The ICI FAQ, which was reviewed by SEC Staff, answers certain of these open questions.[12] In particular, the ICI FAQ states that a fund complex is not required to make an inquiry of all funds in the fund complex when a shareholder meeting is only called for one or a few specific funds.

Other Recent SEC Initiatives

In a September 2016 speech, Andrew Ceresney, director of the SEC's Division of Enforcement discussed enforcement initiatives in the area of auditing.[13] Director Ceresney pointed out that SEC enforcement actions against audit firms generally fall into two categories: (1) audit failures, which occur when an auditor deviates from mandated professional standards in such a way that indicates that the auditor's opinion is false; and (2) auditor independence violations.

Director Ceresney stated that, "[i]n order to be 'public watchdogs,' auditors need to be independent" and that recent enforcement actions for independence violations "reflect the breadth and depth of [the SEC's] commitment to this requirement." He then listed several independence-related enforcement actions which involve:

- preparing bookkeeping and consulting services to affiliates of audit clients;
- audit personnel owning stock in audit clients or affiliates of audit clients;
- providing lobbying services on behalf of audit clients;
- audit personnel or affiliates serving on audit client boards;
- preparing financial statements of brokerage firms who also were audit clients;
- circumventing lead audit partner rotation requirements; and
- including improper indemnification provisions in engagement letters.

Director Ceresney highlighted two recent enforcement settlement orders involving Ernst & Young (E&Y) and several of its partners arising from alleged close personal relationships with senior management of audit clients. He pointed out that these SEC enforcement actions are the first involving auditor independence issues due to close personal relationships with audit clients.

In the first action, the SEC Staff alleged that an audit partner serving on an engagement team had a romantic relationship with a senior manager of an audit client.[14] The supervising partner on the engagement team allegedly was aware of it but failed to perform a reasonable inquiry about the relationship. The SEC's order states that E&Y's policies require engagement teams to follow certain procedures to assess independence. The procedures required engagement team members to be asked whether they had "familial, employment, or financial relationships" with audit clients that could raise independence concerns.[15] However, the SEC Staff alleged that the procedures did not ask about "non-familial close personal relationships between

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an audit firm engagement team member and a client employee in an accounting or financial reporting oversight role."[16]

In the second action, an audit partner was tasked with "repairing" a relationship with an audit client.[17] The SEC Staff alleged that the audit partner overstepped a professional boundary and developed an improperly close friendship with the audit client's chief financial officer (CFO). Over three audit periods, the audit partner allegedly incurred more than $100,000 in expenses entertaining the CFO. The alleged entertainment included regular overnight and out-of-town trips, sporting events, attending other events with the CFO and the CFO's family, and spending leisure time together. The SEC Staff also alleged that other audit partners at E&Y were aware of the relationship and excessive expenses but failed to take appropriate steps to determine whether these expenses were red flags signaling that the audit partner's independence was impaired.

Director Ceresney stated that the two enforcement actions "revealed a systemic independence issue at the firm. . . ." Without admitting or denying the findings in the settlement order, E&Y agreed to pay $9.3 million in combined disgorgement, interest, and penalties; and three firm partners collectively agreed to pay $95,000 in penalties and to be suspended from practicing before the SEC for one to three years. Director Ceresney emphasized that audit firms "must have robust monitoring processes and training on independence issues so that firms comply with independence requirements and so that individual auditors are aware of, and well-versed on, areas of potential independence violations." He also noted that auditor independence violations could potentially be avoided by instituting a "tone at the top" that promotes independence.

Open Questions

Will the Fidelity Letter Prompt Additional Fund Disclosure?

In May 2016, Invesco Ltd. (Invesco) included in a public filing precautionary disclosure reporting that its audit firm was in discussions with SEC Staff regarding the application of the Loan Rule with respect to audit firm lenders that own shares in funds advised by Invesco affiliates. Following Invesco's disclosure, other fund groups added disclosure to their financial statements summarizing independence breaches. These disclosures sometimes state that the fund's audit committee had reviewed the lending relationships of the audit firm and accepted the representations made by the audit firm that the relationships do not impact the audit firm's ability to exercise "objective and impartial judgment." In some cases, minor breaches that would not have been disclosed in the past have been reported in recent public filings. Will the Fidelity Letter and recent disclosures regarding independence violations cause other funds to report auditor independence breaches that they would not previously have disclosed?

How Often Should Inquiries Be Made About Lending Relationships?

The SEC Staff stated in the Fidelity Letter that it expects funds to develop "policies and procedures reasonably designed to ensure that [they] make a reasonable inquiry" when a shareholder meeting is called.[18] The Fidelity Letter advises funds to make "reasonable inquiry" whenever shareholders vote on any of the following matters: (1) election of trustees or directors; (2) the appointment of an independent auditor; or (3) other matters that similarly could influence the objectivity and impartiality of the independent auditor.

In the normal course of business, open-end funds, including ETFs, do not hold regular shareholder meetings to vote on any of the above matters. In contrast, New York Stock Exchange (NYSE) rules require listed closed-end funds to hold annual shareholder meetings to elect directors and to approve the appointment of the audit firm. Many advisers to open-end funds also manage closed-end funds and some advisers are subsidiaries of public companies that hold annual stockholder meetings. Should open-end funds consider adopting a policy of regular periodic reviews of ten-percent

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shareholders even in years when they do not call a shareholder meeting?

The ICI FAQ recognizes that audit firms and funds may choose to examine 10 percent ownership throughout the year. Although funds are not required to make an inquiry unless a matter that could influence the objectivity and impartiality of the independent auditor is voted on, some funds may decide it is a good practice.

What Constitutes a "Reasonable" Inquiry?

The Fidelity Letter states that one possible approach to making a reasonable inquiry could be to review available ownership records and contact shareholders to determine whether an audit firm's lender is a 10 percent owner of fund shares. In some cases, audit firms may need to ask their lenders about the nature of their ownership and whether the lender exercises discretionary voting authority. The ICI FAQ notes that a fund has flexibility to develop policies and procedures that are best suited to its organization.

To determine whether an entity is a 10 percent owner or exercises discretionary voting authority, the ICI FAQ suggests that a fund mail "negative consent" letters to 10 percent owners that have a lending relationship with the audit firm.[19] The ICI FAQ recommends that the letters inform shareholders that the fund will assume that the shareholder either does not own of record or beneficially more than 10 percent or that it will not exercise discretionary voting authority unless the fund receives a written response indicating otherwise.

The ICI FAQ offers guidance that negative consent letters are reasonable "as long as the letters are mailed with sufficient time for the entities to respond."[20] The ICI FAQ also notes that "[t]he inquiry need only extend to the fund or funds that are seeking shareholder approval."[21] Therefore, other funds in the fund complex do not need to make the same inquiry.

Depending on the results of the inquiry, it may be appropriate for a fund or its audit firm to consult with the SEC's Office of Chief Accountant for further guidance. The ICI FAQ also states that some circumstances may require a fund to terminate the audit firm in light of a Loan Rule violation.

What If a Lender Does Vote Fund Shares?

One condition of the Fidelity Letter is that the lending institution not exercise voting authority. The Fidelity Letter requires that if a "Fidelity Entity determines as a part of [its] inquiry that an institution in a Lending Relationship in fact exercises discretionary voting authority with respect to at least 10 percent of the Fidelity Entity's shares, the Fidelity Entity would not rely on this relief and would instead take other appropriate actions, consistent with its obligations under the federal securities laws."[22]

The Fidelity Letter and the ICI FAQ do not provide guidance when a lender does vote more than 10 percent of a fund's shares. The reference to the "the Fidelity Entity" suggests that a violation with respect to one fund in a fund complex would not disqualify an audit firm from being independent with respect to other funds or Adviser Affiliates. However, neither the Fidelity Letter nor the ICI FAQ provide guidance regarding circumstances where an audit firm could still serve as independent auditor for a fund even though the audit firm's lender has voted more than 10 percent of the shares of the fund.

May a 10 Percent Owner Limit Voting Authority?

The ICI FAQ confirms that an intermediary that votes on behalf of a client (that is, shares held in street name) in reliance on NYSE Rule 452 exercises discretionary voting authority. Under NYSE Rule 452, NYSE members are allowed to vote uninstructed proxies on behalf of their fund customers on uncontested, routine matters, such as the election of board members or the reappointment of independent auditors. Because this constitutes discretionary voting authority, a fund may continue to rely on the Fidelity Letter if the intermediary sufficiently limits its discretion to vote those shares.

The ICI FAQ advises that a fund may continue to rely on the Fidelity Letter if the greater-than-10

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percent owner has taken steps to limit its discretion to vote its shares. For example, the 10 percent owner may limit voting authority by:

- "mirror voting";
- passing through the vote to an unaffiliated third party;
- voting in accordance with the recommendations of an independent, third-party proxy voting advisory firm;
- holding shares in an irrevocable voting trust; or
- otherwise relinquishing its right to vote such shares prior to or as of the record date of any matter that could influence the objectivity or impartiality of the independent auditor.

Can a Loan Be Transferred to an Affiliate of the Lender?

In some cases an affiliate of an audit firm's lender might own more than 10 percent of the shares of a fund that is an audit client. In footnote 5 of the Fidelity Letter, the SEC Staff points out that the Loan Rule only applies to a record or beneficial owner and companies "that control the record or beneficial owner of more than ten percent of the shares of the entity, and not entities controlled by or under common control with the owner." This suggests that an outstanding loan can be transferred by the owner of shares to a subsidiary or other affiliate in order to avoid a violation of the Loan Rule.

May a Lender Vote Less Than 10 Percent to Avoid a Violation?

A lender is considered to have a beneficial ownership interest when it holds fund shares for its clients in a custody account and has discretionary voting authority. An audit firm can rely on the Fidelity Letter when its lender has delegated voting authority to an independent third party, such as a proxy advisory firm. Can an audit firm also rely on the Fidelity Letter where a lender retains authority to vote some of the shares and only transfers voting authority sufficient to bring the vote cast by the lender under 10 percent?

Other Takeaways from the ICI FAQ

The ICI FAQ discusses whether funds have conducted a reasonable inquiry where Cede & Co.[23] holds of record all of a closed-end fund's shares and no reports of beneficial ownership in excess of 10 percent have been filed with the SEC.[24] The ICI FAQ states that it is not sufficient to simply look at whether ownership reports have been filed. It notes that those filings do not cover instances when broker-dealers might be deemed record owner of more than ten percent of a closed-end fund's shares and vote those shares with some discretion.

The ICI FAQ notes that even the election of "less than a majority of fund board members" could create an independence issue.[25] The ICI FAQ points out that, even though only a minority is up for election, each board member may have the ability to "influence the objectivity and impartiality of the independent auditor."[26] The ICI FAQ recommends that a fund consider making a reasonable inquiry about the impact of the Loan Rule whenever any board member is up for election.

Conclusion

The consequences of a Loan Rule violation could be severe. A fund could be required to: (1) find a new independent audit firm; (2) have prior financial statements reaudited by a new firm; and (3) stop offering new shares until the fund obtains an opinion from a qualified independent audit firm.

In many instances, funds are innocent bystanders when an audit firm fails to comply with independence rules. Violations often cannot be detected by funds despite reasonable inquiries and assurances. However, the adverse business and legal consequences fall on the funds to a significant extent because it is their financial statements that may fail to comply with SEC rules.

Funds already have a limited selection of qualified audit firms from which to choose. Audit firms outside the "big four" may not have the capacity, resources, or expertise to audit a large fund complex. One unintended consequence of a strict application

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of the Loan Rule in the fund industry context may be that funds become even more limited in their options for capable audit firms.

The Fidelity Letter relief is temporary and will expire 18 months from the date it was issued. The SEC Staff may decide to extend the no-action relief in its present or a modified form. A better approach may be for the SEC Staff to publish proposed amendments to the Loan Rule that would narrow the overly broad application to fund complexes. This would give audit firms and the fund industry an opportunity to comment on possible solutions.

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NOTES

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

2 Frequently Asked Questions about the SEC Staff Letter on Auditor Independence and the "Loan Provision," Investment Company Institute, (September 23, 2016), Available at *https://www.ici.org/my_ici/memorandum/ci.memo30258.idc*

3 Fidelity Letter at 2.

4 Preliminary Note 2 to Rule 2-01 of Regulation S-X.

5 Rule 2-01(c)(1) of Regulation S-X.

6 Rule 2-01(c)(1)(ii)(A) of Regulation S-X.

7 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."

8 Rule 2-01(f)(14) of Regulation S-X.

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

10 Fidelity Letter at 4.

11 *Id.* at 6.

12 The ICI FAQ states that review by the SEC Staff does not indicate agreement with, or approval of, its contents.

13 Andrew Ceresney, "The SEC Enforcement Division's Focus on Auditors and Auditing," available at, *https://www.sec.gov/news/speech/ceresney-enforcement-focus-on-auditors-and-auditing.html.*

14 *In the matter of Ernst & Young LLP and Gregory S. Bednar, CPA,* Exchange Act Rel. No. 78872 (September 19, 2016);

15 *Id*. at 9.

16 *Id*.

17 *In the matter of Ernst & Young LLP, Robert J. Brehl, CPA, Pamela J. Hartford, CPA, and Michael T. Kamienski, CPA*, Exchange Act Rel. No. 78873 (September 19, 2016).

18 *Fidelity Letter* at n.11.

19 ICI FAQ #3.

20 *Id*.

21 ICI FAQ #4.

22 Fidelity Letter at 5.

23 Cede & Co. is the nominee name for The Depository Trust Company (DTC). The DTC is a custodian that holds shares for financial institutions in book-entry form in order to immobilize securities and expedite their sale and transfer.

24 Pursuant to Section 13 and Section 16 of the Exchange Act of 1934.

25 ICI FAQ at 9.

26 *Id*.

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