### List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

### The Proposed Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA proposes to amend 14 CFR part 39 as follows:

## PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

**Authority:** 49 U.S.C. 106(g), 40113, 44701.

### § 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

**Airbus Helicopters:** Docket No. FAA–2017–1124; Product Identifier 2017–SW–073–AD.

**(a) Applicability**

This AD applies to Airbus Helicopters Model AS332C, AS332C1, AS332L, and AS332L1 helicopters, certificated in any category, with a cabin sliding plug door installed in accordance with Airbus Helicopters modification (MOD) 0722338, except helicopters with a plug door jettison system installed in accordance with MOD 0725366.

**(b) Unsafe Condition**

This AD defines the unsafe condition as failure of a cabin sliding door to jettison, which could prevent helicopter occupants from evacuating the helicopter during an emergency.

**(c) Comments Due Date**

We must receive comments by July 9, 2018.

**(d) Compliance**

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

**(e) Required Actions**

Within 110 hours time-in-service (TIS) or before the next operation over water, whichever occurs first, inspect the jettisoning mechanism of the left-hand and right-hand cabin doors for correct operation:

(1) Pull the jettisoning handle and determine whether the cable clamp contacts the top or bottom horizontal cables, using as a reference the photographs under paragraph 3.B.2 of Airbus Helicopters ASB No. AS332–52.00.56, Revision 0, dated January 30, 2017 (ASB).

(2) If there is contact between a cable clamp and a horizontal cable, before further flight, install both cable clamps as depicted in the bottom photograph under paragraph 3.B.2 of the ASB.

**(f) Alternative Methods of Compliance (AMOCs)**

(1) The Manager, Safety Management Section, Rotorcraft Standards Branch, FAA, may approve AMOCs for this AD. Send your proposal to: Matt Fuller, Senior Aviation Safety Engineer, Safety Management Section, Rotorcraft Standards Branch, FAA, 10101 Hillwood Pkwy., Fort Worth, TX 76177; telephone (817) 222–5110; email *9-ASW-FTW-AMOC-Requests@faa.gov.*

(2) For operations conducted under a 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office before operating any aircraft complying with this AD through an AMOC.

**(g) Additional Information**

(1) Eurocopter Service Bulletin No. 332–52.00.28, Revision 1, dated April 29, 1998, which is not incorporated by reference, contains additional information about the subject of this AD. For service information identified in this AD, contact Airbus Helicopters, 2701 N Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.helicopters.airbus.com/website/en/ref/Technical-Support_73.html.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 10101 Hillwood Pkwy., Room 6N–321, Fort Worth, TX 76177.

(2) The subject of this AD is addressed in European Aviation Safety Agency (EASA) AD No. 2017–0022, dated February 8, 2017. You may view the EASA AD on the internet at *http://www.regulations.gov* in the AD Docket.

**(h) Subject**

Joint Aircraft Service Component (JASC) Code: 5200, Doors.

Issued in Fort Worth, Texas, on May 1, 2018.

**Lance T. Gant,**

*Director, Compliance & Airworthiness Division, Aircraft Certification Service.*

[FR Doc. 2018–09740 Filed 5–7–18; 8:45 am]

BILLING CODE 4910–13–P

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## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 210

**[Release No. 33–10491; 34–83157; IC–33091; IA–4904; FILE NO. S7–10–18]**

**RIN 3235–AM01**

## Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (''Commission'') is proposing to amend its auditor independence rules to refocus the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client at any time during an audit or professional engagement period. The proposed amendments would focus the analysis solely on beneficial ownership rather than on both record and beneficial ownership; replace the existing 10 percent bright-line shareholder ownership test with a ''significant influence'' test; add a ''known through reasonable inquiry'' standard with respect to identifying beneficial owners of the audit client's equity securities; and amend the definition of ''audit client'' for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client. The Commission is also requesting comment on certain other potential amendments to its auditor independence rules.

**DATES:** Comments should be received on or before July 9, 2018.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission's internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number S7–10–18 on the subject line.

*Paper Comments*

- Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–10–18. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available

publicly. Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the ''Stay Connected'' option at *www.sec.gov* to receive notifications by email.

**FOR FURTHER INFORMATION CONTACT:** Giles T. Cohen, Deputy Chief Counsel, or Peggy Kim, Senior Special Counsel, Office of the Chief Accountant, at (202) 551–5300; Alison Staloch, Chief Accountant, Chief Accountant's Office, Division of Investment Management, at (202) 551–6918; or Joel Cavanaugh, Senior Counsel, Investment Company Regulation Office, Division of Investment Management, at (202) 551–6792, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** We are proposing amendments to Rule 2–01 of Regulation S–X.[1]

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## I. Background

### *A. The Loan Provision of Regulation S–X*

We are proposing to amend certain provisions of our auditor independence rules. The Commission has long considered auditor independence to be essential to reliable financial reporting and critical to the effective functioning of the U.S. capital markets.[2] Independent auditors have an important public trust.[3] Many Commission regulations require entities to file or furnish financial statements that have been audited by an independent auditor; such entities include operating companies, registered investment companies, registered investment advisers, pooled investment vehicles,[4] and registered broker-dealers.[5]

The Commission's auditor independence standard is set forth in Rule 2–01 of Regulation S–X, which requires auditors[6] to be independent of their audit clients both ''in fact and in appearance.''[7] Rule 2–01(b) provides that the Commission will not recognize an accountant as independent with respect to an audit client if the accountant is not (or if a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not) capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.[8]

Rule 2–01(c) sets forth a nonexclusive list of circumstances that the Commission considers to be inconsistent with the independence standard in Rule 2–01(b), including certain direct financial relationships between an accountant and audit client and other circumstances where the accountant has a financial interest in the audit client.[9] In particular, the restriction on debtor-creditor relationships in Rule 2–01(c)(1)(ii)(A) (the ''Loan Provision'') generally provides that an accountant is not

[1] 17 CFR 210.2–01.

[2] *See generally* Proposed Rule: Revision of the Commission's Auditor Independence Requirements, Release No. 33–7870 (June 30, 2000) (''2000 Proposing Release''), *available at https://www.sec.gov/rules/proposed/34-42994.htm.*

[3] The U.S. Supreme Court in describing the independent auditor's responsibility, stated that the accountant's ''public watchdog'' function ''demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.'' *United States* v. *Arthur Young,* 465 U.S. 805, 818 (1984).

[4] In this Release, we use the term ''pooled investment vehicle'' to refer to a limited partnership, limited liability company, or another type of pooled investment vehicle for which the pooled investment vehicle's investment adviser relies on paragraph (b)(4) of Rule 206(4)–2 (the ''Custody Rule'') under the Advisers Act. In general, paragraph (b)(4) of the Custody Rule provides conditions under which an investment adviser is not required to comply with provisions of the Custody Rule relating to the delivery of certain notices and account statements and is deemed to have complied with the surprise examination requirements of the rule with respect to an account that is a limited partnership, limited liability company or other pooled investment vehicle that is subject to audit (as defined in Rule 1–02(d) of Regulation S–X). In order to rely on this ''audit exception,'' the audit must be performed by an independent public accountant that: (i) Meets the standards in Rule 2–01(b) and (c) of Regulation S–X; and (ii) is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the Public Company Accounting Oversight Board (''PCAOB'') in accordance with its rules. Many advisers to private funds rely on the audit exception. A ''private fund'' is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act. *See* Section 202(a)(29) of the Investment Advisers Act.

[5] For example, Items 25 and 26 of Schedule A to the Securities Act of 1933 (''Securities Act'') [15 U.S.C. 77aa(25) and (26)] and Section 17(e) of the Securities Exchange Act of 1934 (''Exchange Act'') [15 U.S.C. 78q] expressly require that financial statements be certified by independent public or certified accountants. In addition, Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act [15 U.S.C. 78l and 78m], Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 (''Investment Company Act'') [15 U.S.C. 80a–8 and 80a–29], and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 (''Advisers Act'') [15 U.S.C. 80b–3(c)(1)] authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Paragraph (f)(1) of Rule 17a–5 under the Exchange Act [17 CFR 240.17a–5(f)(1)] requires that for audits under paragraph (d) of Rule 17a–5 of broker-dealers registered with the Commission, an independent public accountant must be independent in accordance with Rule 2–01 of Regulation S–X. *See also id.* (discussing Rule 206(4)–2 under the Advisers Act).

[6] Rule 2–01 refers to ''accountants'' rather than ''auditors.'' We use these terms interchangeably in this Release.

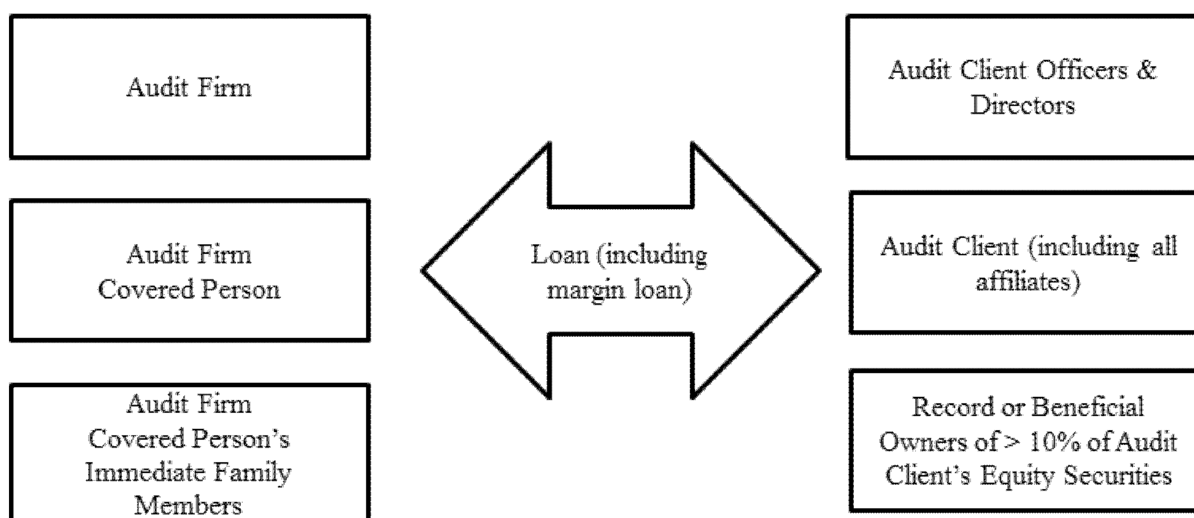
[7] *See* Preliminary Note 1 to Rule 2–01 and Rule 2–01(b) of Regulation S–X. *See also United States* v. *Arthur Young & Co.,* 465 U.S. 805, 819 n.15 (1984) (''It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional.'').

[8] *See* Rule 2–01(b) of Regulation S–X.

[9] *See* Rule 2–01(c) of Regulation S–X; *see also Revision of the Commission's Auditor Independence Requirements,* Release No. 33–7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] (''2000 Adopting Release'') *available at https://www.sec.gov/rules/final/33-7919.htm,* at 65 FR 76009 (''The amendments [to Rule 2–01 adopted in 2000] identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2–01(b). The relationships addressed include, among others, financial, employment, and business relationships between auditors and audit clients . . . .'').

independent when (a) the accounting firm, (b) any covered person [10] in the accounting firm (*e.g.,* the audit engagement team and those in the chain of command), or (c) any of the covered person's immediate family members has any loan (including any margin loan) to or from (x) an audit client, or (y) an audit client's officers, directors, or (z) record or beneficial owners of more than 10 percent of the audit client's equity securities.[11] We note that simply because a lender to an auditor holds 10 percent or less of an audit client's equity securities does not, in itself, establish that the auditor is independent under Rule 2–01 of Regulation S–X. The general standard under Rule 2–01(b) and the remainder of Rule 2–01(c) still apply to auditors and their audit clients regardless of the applicability of the Loan Provision.

Figure 1. Loan Provision Relationships




Thus, in the above illustration, pursuant to the Loan Provision, a lending relationship between any entity in the left hand column and any entity in the right-hand column impairs independence, unless an exception applies.

When the Commission proposed the Loan Provision, it noted that a debtor-creditor relationship between an auditor and its audit client reasonably could be viewed as ''creating a self-interest that competes with the auditor's obligation to serve only investors' interests.'' [12] The Commission's concern about a competing self-interest extended beyond loans directly between the auditor and its audit client to loans between the auditor and those shareholders of the audit client who have a ''special and influential role'' with the audit client.[13] As a proxy for identifying a ''special and influential role,'' the Commission adopted a bright-line test for loans to or from a record or beneficial owner of more than 10 percent of an audit client's equity securities.[14]

Under Rule 2–01(f)(6) of Regulation S–X, the term ''audit client'' is defined to include any affiliate of the entity whose financial statements are being audited.[15] Rule 2–01(f)(4) provides that ''affiliates of the audit client'' include entities that control, are controlled by, or are under common control with the audit client. As a result, generally, an accounting firm is not independent under the 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.

In addition, the term ''affiliate of the audit client'' includes each entity in an investment company complex (''ICC'') of which the audit client is a part.[16] Accordingly, in the ICC context, an accounting firm is considered not independent under the Loan Provision if it has a lending relationship with an entity having record or beneficial ownership of more than 10 percent of any entity within the ICC, regardless of

[10] *See* Rule 2–01(f)(11) of Regulation S–X.

[11] *See* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76035.

[12] *See* 2000 Proposing Release, *supra* footnote 2, at 65 FR 76034–76035.

[13] *See* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76035.

[14] The Commission proposed that the Loan Provision include a five-percent equity ownership threshold, but raised the threshold to 10 percent when it adopted the Loan Provision. *See* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76035. As the basis for its use of a 10 percent threshold, the Commission pointed to similar 10 percent ownership thresholds elsewhere in the federal securities laws, including Rule 1–02(r) of Regulation S–X (defining ''principal holder of equity securities''), Rule 1–02(s) of Regulation S–X (defining ''promoter''), and Section 16 of the Exchange Act (requiring reporting to the Commission of beneficial ownership information by directors, officers and beneficial owners of more than 10 percent of any class of equity securities of an issuer). *Id.*

[15] *See* Rule 2–01(f)(6) of Regulation S–X.

[16] *See* Rule 2–01(f)(4)(iv) of Regulation S–X (defining ''affiliate of the audit client''). ''Investment company complex'' is defined in Rule 2–01(f)(14) of Regulation S–X to include: ''(A) An investment company and its investment adviser or sponsor; (B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity: (1) Is an investment adviser or sponsor; or (2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and (C) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the [1940 Act] that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section.''

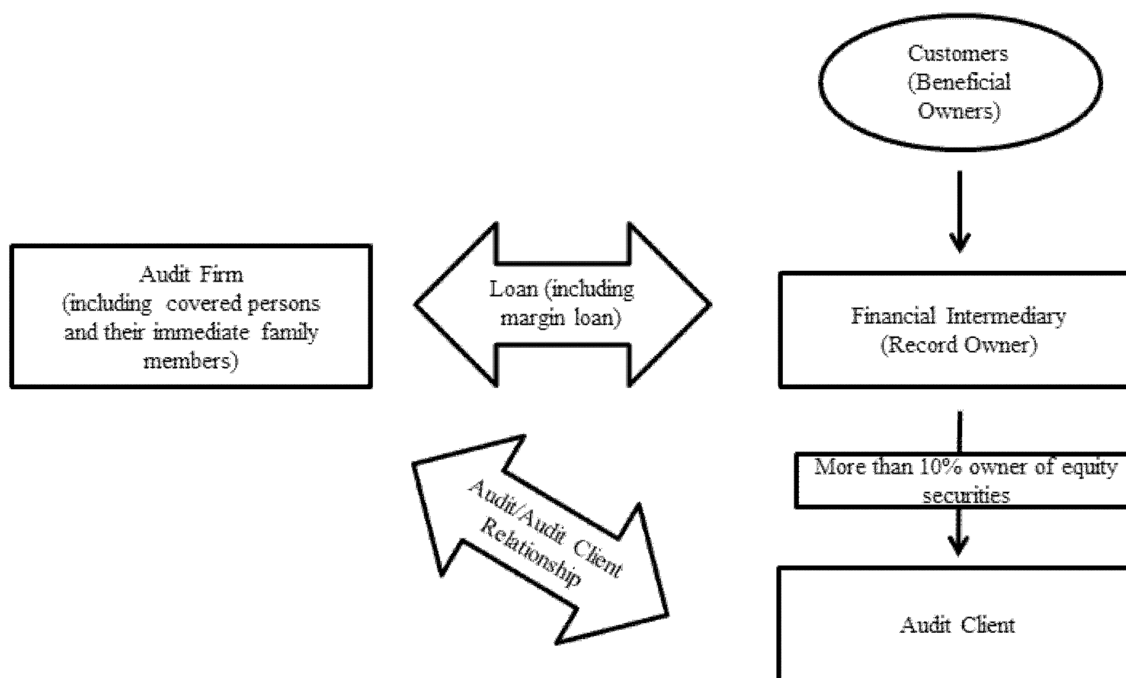
which entities in the ICC are audited by the accounting firm.

*B. Application of the Current Loan Provision*

The Commission has become aware that, in certain circumstances, the existing Loan Provision may not be functioning as it was intended, under current market conditions. It also presents significant practical challenges.[17] Registered investment companies, pooled investment vehicles, and registered investment advisers have articulated concerns about the Loan Provision in both public disclosures[18] and, together with their auditors, in extensive consultations with Commission staff.[19] It has become clear that there are certain fact patterns where an auditor's objectivity and impartiality is not impaired despite a failure to comply with the requirements of the Loan Provision.[20]

One challenge associated with the Loan Provision is that it applies to both ''record'' and ''beneficial'' owners of the audit client's equity securities. However, publicly traded shares, as well as certain fund shares, often are registered in the name of a relatively small number of financial intermediaries[21] as ''record'' owners for the benefit of their clients or customers. Certain of these financial intermediaries may also be lenders to public accounting firms or be affiliated with financial institutions that may be lenders to public accounting firms.[22] As a result, audit clients may have financial intermediaries that own, on a ''record'' basis, more than 10 percent of the issuer's shares and are also lenders to public accounting firms, covered persons of accounting firms, and their immediate family members, or are affiliated with companies that are lenders to public accounting firms (see Figure 2 below for illustration). However, these financial intermediaries are not ''beneficial'' owners. They also may not have control over whether they are ''record'' owners of more than 10 percent of the issuer's shares.

Figure 2. Audit Firm is not independent under the Loan Provision when a Financial Intermediary that is a lender to the Audit Firm is also a record owner of more than 10 percent of the equity securities of the Audit Client.




[17] The audit committees of registered investment companies may be focused on this issue because, under the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley Act''), audit committees are responsible for the selection, compensation and oversight of such funds' independent auditors. *See* Rule 10A–3 under the Exchange Act [17 CFR 240.10A–3]. In addition, for audits conducted pursuant to PCAOB standards, the auditor is required to notify the audit committee of matters that may reasonably bear upon the independence of the auditor. *See* PCAOB Rule 3526.

[18] Several funds and investment advisers have noted concerns regarding the Loan Provision in their public filings with the Commission. *See, e.g.,* AIM Investment Securities Funds (Invesco Investment Securities Funds) Form N–CSR filed on May 12, 2016; Invesco Mortgage Capital Inc. Form 10–Q filed on May 10, 2016; iShares Trust Form N–CSR filed on June 6, 2016; Delaware Investments Colorado Municipal Income Fund, Inc. Form N–CSR filed on June 6, 2016; Goldman Sachs Trust Form N–CSR filed on June 6, 2016; Advent International Corp. Form ADV filed on March 30, 2016; NB Alternatives Advisers LLC Form ADV filed on June 29, 2016; Indaba Capital Management, L.P. Form ADV filed on March 30, 2016; and MFS Government Markets Income Trust Schedule 14A filed on August 31, 2016.

[19] Staff in the Office of the Chief Accountant (OCA staff) regularly engage in consultations with issuers regarding accounting, financial reporting, and auditing concerns or questions, including application of the auditor independence rules.

[20] Challenges associated with the Loan Provision have also arisen with issuers other than funds, although not to the same extent. For example, a foreign private issuer (''FPI'') and its external auditor encountered compliance issues with the Loan Provision as a result of the FPI's use of a depositary bank to hold its American Depositary Shares. In that case, the depositary bank was the record holder, but not the beneficial owner, of more than 10 percent of the underlying equity shares of the FPI while also having a lending relationship with the auditor. *See, e.g.,* JMU Ltd. Form 20–F, filed on May 26, 2017.

[21] *See infra* footnote 23.

[22] We note that the Loan Provision can be implicated by lending relationships between an auditing firm and those that control the record or beneficial owner of more than 10 percent of the shares of an audit client (*i.e.,* entities that are under common control with or controlled by the record or beneficial owner are not as such implicated by the Loan Provision).

For example, open-end funds, such as mutual funds, may face significant challenges, because the record ownership percentages of open-end funds may fluctuate greatly within a given period for reasons completely out of the control or knowledge of a lender who is also a fund shareholder of record. To be more specific, as a result of underlying customer activity in an omnibus account (such as when beneficial owners purchase or redeem their shares in an open-end fund) or as a result of the activity of other record or beneficial owners, the record ownership of a lender that is a financial intermediary holding fund shares for customers may exceed, or conversely fall below, the 10 percent threshold within a given period without any affirmative action on the part of the financial intermediary.[23] In this scenario, the financial intermediary's holdings might constitute less than 10 percent of a mutual fund and, as a result of subsequent redemptions by beneficial owners through other non-affiliated financial intermediaries, the same investment could then constitute more than 10 percent of the mutual fund. However, regardless of their diligence in monitoring compliance, the financial intermediary, the fund, or the auditor may not know that the 10 percent threshold had been exceeded until after the fact.

Another practical challenge is that the auditor independence rules' broad definition of the term ''audit client'' gives rise to results that are out of step with the purpose of the rule and that can have adverse effects when applied in the specific context of the Loan Provision. As described above, the Loan Provision applies not only to an entity that the audit firm is auditing but also to those entities that are ''affiliated'' with the audit client.[24] The auditor independence rules broadly define an ''affiliate of the audit client'' to include, among other things, both (a) an entity that is under common control with the audit client; and (b) each entity in an ICC when the audit client is part of that ICC.[25]

Open-end funds are often part of large and varied ICCs, and multiple accounting firms may be retained to perform audits of various entities within the ICC. If an accounting firm is not independent under the Loan Provision with respect to only one of a given ICC's funds, no fund or other entity in the ICC can engage or retain that accounting firm as an independent auditor consistent with Rule 2–01 of Regulation S–X. An auditor to one fund in an ICC thus must seek information regarding the record and beneficial owners of the equity securities of *all* of the other funds (and other entities) in the ICC and such owner's affiliates (see Figure 3 below for illustration). Other funds in the ICC that are not audited by the requesting auditor are not required to provide this information, and may only provide it, if at all, after negotiation and the establishment of information-sharing protocols, all of which can require substantial time and expense incurred by auditors and funds. Even where funds not audited by this auditor do provide information regarding the owners of their equity securities, the fact that fund shares often are held in omnibus accounts registered in the name of financial intermediaries creates further challenges in identifying the shares' beneficial owners to determine if they are lenders to the auditing firm that own more than 10 percent of the fund's equity securities.[26]

Further, not only loans to accounting firms but also loans to certain ''covered persons'' at such firms and their immediate family members may implicate the Loan Provision.[27] As a result, certain lending relationships with members of the audit engagement team, individuals generally in the supervisory reporting chain for the audit, certain accounting firm employees in the same primary office as the lead engagement partner, and other accounting firm employees—or with immediate family members of any of those persons—could be found to impair the audit firm's independence.[28]

[23] Financial intermediaries such as broker-dealers, banks, trusts, insurance companies and retirement plan third-party administrators perform the recordkeeping of open-end fund positions and provide services to customers, including beneficial owners and other intermediaries and, in most cases, aggregate their customer records into a single or a few ''omnibus'' accounts registered in the intermediary's name on the fund transfer agent's recordkeeping system. Shares of other types of registered investment companies, such as closed-end funds, also are frequently held by broker-dealers and other financial intermediaries as record owners on behalf of their customers, who are not required and may be unwilling to provide, information about the underlying beneficial owners to accounting firms, and particularly accounting firms that do not audit the fund. In addition, a financial intermediary may act as an authorized participant or market maker to an exchange-traded fund (''ETF'') and be the holder of record or beneficial owner of more than 10 percent of an ETF.

An open-end fund, or open-end company, is a management company that is offering for sale or has outstanding any redeemable securities of which it is the issuer. A closed-end fund, or closed-end company, is any management company other than an open-end company. *See* Section 5 of the Investment Company Act [15 U.S.C. 80a–5]. ETFs registered with the Commission are organized either as open-end management companies or unit investment trusts. *See* Section 4 of the Investment Company Act [15 U.S.C. 80a–4] (defining the terms ''management company'' and ''unit investment trust''). References to ''funds'' in this Release include ETFs, unless specifically noted.

[24] *See* Rule 2–01(f)(6) of Regulation S–X.

[25] *See* Rule 2–01(f)(4) of Regulation S–X, in which an ''affiliate of the audit client'' is defined to include the following:

(i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

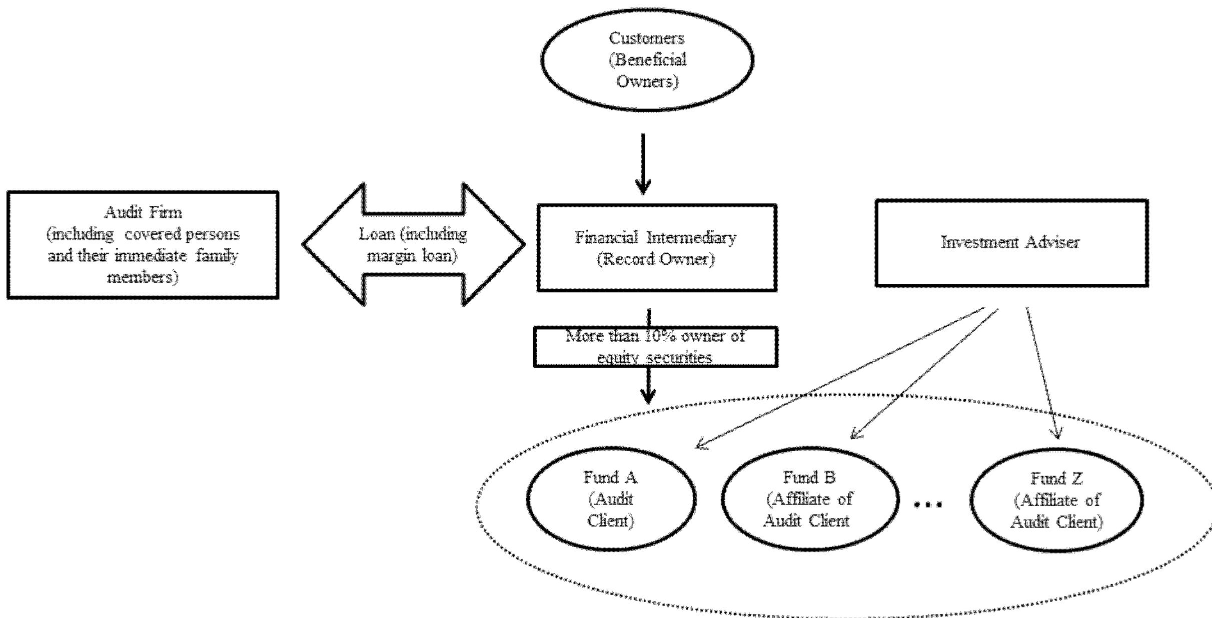
(iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

[26] In some cases, financial intermediaries such as broker-dealers or banks hold fund shares on behalf of other financial intermediaries, such as retirement plan administrators or other broker-dealers, creating multiple layers of intermediaries between the fund and the beneficial owners of its shares. *See also, e.g., Mutual Fund Redemption Fees,* Release No. IC–27504 (Sept. 27, 2006) [71 CFR 58257 (Oct. 3, 2006)] at 58258 (discussing application of Rule 22c–2 under the Investment Company Act to ''chains of intermediaries'').

[27] *See* Rule 2–01(c)(1)(ii) of Regulation S–X.

[28] *See* Rule 2–01(f)(11) of Regulation S–X (definition of ''covered persons'').

Figure 3. Audit Firm that has a loan with a Financial Intermediary that owns more than 10 percent of the equity securities of one Audit Client (Fund A) in an ICC is also not independent with respect to other funds in the ICC (Fund B through Fund Z). Since Audit Firm performs and issues an audit report for one fund in an ICC (Fund A), Funds B, C, D . . . and Z (other funds in the ICC) are also considered to be Audit Clients due to their affiliate status.




The Commission understands that accounting firms use loans to help finance their core business operations. Accounting firms frequently obtain financing to pay for their labor and out-of-pocket expenses before they receive payments from audit clients for those services. Accounting firms also use financing to fund current operations and provide capital to fund ongoing investments in their audit methodologies and technology. Accounting firms borrow from commercial banks or through private placement debt issuances, typically purchased by large financial institutions, both of which give rise to debtor-creditor relationships.[29] For creditor diversification purposes, credit facilities provided or arranged by commercial banks are often syndicated among multiple financial institutions, thereby expanding the number of lenders to an accounting firm. As a result, accounting firms typically have a wide array of lending arrangements. These arrangements facilitate firms' provision of audit services to investors and other market participants, but also multiply the number of lenders that may also be record or beneficial owners of securities in audit clients and that must be analyzed under the Loan Provision.

The current market conditions that have enabled these accounting firms' financing methods appear to have resulted in various scenarios in which the Loan Provision deems an accounting firm's independence to be impaired, notwithstanding that the relevant facts and circumstances regarding the relationships between the auditor and the audit client suggest that in most cases the auditor's objectivity and impartiality do not appear to be affected as a practical matter. Nevertheless, auditors and audit committees may feel obligated to devote substantial resources to evaluating potential instances of noncompliance with the existing Loan Provision, which could distract auditors' and audit committees' attention from matters that may be more likely to bear on the auditor's objectivity and impartiality.[30] Audit committees' receipt of a high volume of communications of such relationships may dilute the impact of communications that identify issues that may actually raise concerns about an auditor's independence.[31]

Similarly, numerous violations of the independence rules that no reasonable person would view as implicating an auditor's objectivity and impartiality could desensitize market participants to other, more significant violations of the

[29] The Commission further understands that insurance companies may purchase accounting firms' private placement notes. Insurance companies may also act as sponsors of insurance products, and may be record owners, on behalf of contract holders, of certain investment companies' equity securities.

[30] Auditors are required to communicate any relationships, including lending relationships, with the audit client that may reasonably be thought to bear on independence to the audit committee at least annually. *See, e.g.,* PCAOB Rule 3526 (requiring a registered public accounting firm, at least annually with respect to each of its audit clients, to: (1) Describe, in writing, to the audit committee of the audit client, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence; (2) discuss with the audit committee of the audit client the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm; (3) affirm to the audit committee of the audit client, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and (4) document the substance of its discussion with the audit committee of the audit client.

[31] In this Release, we use the term ''audit committee,'' when referring to funds, generally to refer to audit committees established by a fund's board of directors or trustees or, where no formal audit committee exists as may be the case for certain private funds, for example, those responsible for the governance of the fund.

independence rules. Respect for the seriousness of these obligations is better fostered through limiting violations to those instances in which the auditor's independence would be impaired in fact or in appearance.

Moreover, searching for, identifying, and assessing noncompliance or potential non-compliance with the Loan Provision and reporting these instances to audit committees also may generate significant costs for entities and their advisers and auditors, which costs are ultimately borne by shareholders. These costs are unlikely to entail corresponding benefits to the extent that the Loan Provision's breadth identifies and requires analysis of circumstances that are unlikely to bear on the auditor's independence.

In addition, the compliance challenges associated with the Loan Provision can have broader disruptive effects, particularly for funds.[32] For example, in order for a registered open-end fund to make a continuous offering of its securities, it must maintain a current prospectus by periodically filing post-effective amendments to its registration statement that contain updated financial information audited by an independent public accountant in accordance with Regulation S–X.[33] In addition, the federal securities laws require that investment companies registered under the Investment Company Act transmit annually to shareholders and file with the Commission financial statements audited by an independent registered public accounting firm.[34] Accordingly, noncompliance with the auditor independence rules in some cases can result in affected funds not being able to sell shares, investors not being able to rely on affected financial statements, or funds (and, indirectly, but importantly, their investors) having to incur the costs of re-audits.

In order to provide time for the Commission to address these challenges, and recognizing that funds and their advisers were most acutely affected by the Loan Provision, the Commission staff issued a no-action letter to Fidelity Management & Research Company regarding the application of the Loan Provision (''Fidelity No-Action Letter'').[35] In the Fidelity No-Action Letter, the staff stated that it would not recommend enforcement action to the Commission, even though certain Fidelity entities identified in the letter used audit firms that were not in compliance with the Loan Provision, subject to certain conditions specified in the letter (*e.g.,* that notwithstanding such non-compliance, the audit firm had concluded that it is objective and impartial with respect to the issues encompassed within the engagement).[36] Staff continue to receive inquiries from registrants and accounting firms regarding the application of the Loan Provision, or clarification of the Fidelity No-Action Letter, and requests for consultation regarding issues not covered in the Fidelity No-Action Letter.

## II. Proposed Amendments

### *A. Overview of the Proposed Amendments*

Given the dynamics identified above, we are proposing amendments to Rule 2–01 of Regulation S–X that would result in a rule that we believe would effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality, yet would not include certain extended relationships that are unlikely to present threats to objectivity or impartiality.[37] Specifically, we are proposing amendments that would:

- Focus the analysis solely on beneficial ownership;
- replace the existing 10 percent bright-line shareholder ownership test with a ''significant influence'' test;
- add a ''known through reasonable inquiry'' standard with respect to identifying beneficial owners of the audit client's equity securities; and
- amend the definition of ''audit client'' for a fund under audit to exclude from the provision funds that otherwise would be considered ''affiliates of the audit client.''

The proposed amendments are designed to better focus the Loan Provision on those relationships that, whether in fact or in appearance, could threaten an auditor's ability to exercise objective and impartial judgment. We also are soliciting input on other potential changes to the Loan Provision or Rule 2–01 of Regulation S–X that may be appropriate.

Given that compliance challenges associated with applying the Loan Provision have arisen with entities other than funds, the proposed amendments would apply broadly to entities beyond the investment management industry, including operating companies and registered broker-dealers.

### *B. Focus the Analysis Solely on Beneficial Ownership*

Where a lender to an auditor holds more than 10 percent of the equity securities of that auditor's audit client either as a beneficial owner or as a record owner, the Commission's rules indicate that the auditor is not independent of the audit client. The record owner exceeding 10 percent may be a broker-dealer, custodian, or an intermediary omnibus account holder for its customers. Thus, as noted in Section I.B., the existing Loan Provision applies where a lender holds the audit client's equity securities of record, even though the lender may be unable to influence an audit client through its holdings of the audit client's equity securities, and may have no economic incentive to do so.[38]

[32] Registered investment advisers that have custody of client funds or securities also face compliance challenges from the Loan Provision. These advisers generally are required under the Custody Rule to obtain a surprise examination conducted by an independent public accountant or, for pooled investment vehicles, may be deemed to comply with the requirement by distributing financial statements audited by an independent public accountant to the pooled investment vehicle's investors. An auditor's inability, or potential inability, to comply with the Loan Provision raises questions concerning an adviser's ability to satisfy the requirements of the Custody Rule.

[33] *See generally* Section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)] and Item 27 of Form N–1A.

[34] *See* Rules 30e–1 and 30b2–1 under the Investment Company Act.

[35] *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.* The June 20, 2016 Letter provided temporary no-action relief, and was to expire 18 months from the issuance date. On September 22, 2017, the staff extended the June 20, 2016 Letter until the effective date of any amendments to the Loan Provision adopted by the Commission that are designed to address the concerns expressed in the June 20, 2016 Letter. *See* No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (Sept. 22, 2017) (''September 22, 2017 Letter''), *available at https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm.*

[36] The June 20, 2016 Letter described the following circumstances, each of which could have potential implications under the Loan Provision: (i) ''An institution that has a lending relationship with an Audit Firm holds of record, for the benefit of its clients or customers (for example, as an omnibus account holder or custodian), more than 10 percent of the shares of a Fidelity Entity;'' (ii) ''An insurance company that has a lending relationship with an Audit Firm holds more than 10 percent of the shares of a Fidelity Fund in separate accounts that it maintains on behalf of its insurance contract holders;'' and (iii) ''An institution that has a lending relationship with an Audit Firm and acts as an authorized participant or market maker to a Fidelity ETF and holds of record or beneficially more than 10 percent of the shares of a Fidelity ETF.''

[37] *See* Rule 2–01(b) of Regulation S–X.

[38] The financial gain of beneficial owners is tied to the performance of their investment and as such, beneficial owners may have stronger incentives to influence the auditor's report. Record owners, on the other hand, likely do not benefit directly from the performance of securities of which they are

Continued

Under the proposed amendments, the Loan Provision would apply only to beneficial owners of the audit client's equity securities and not to those who merely maintain the audit client's equity securities as a holder of record on behalf of their beneficial owners.[39] We believe that tailoring the Loan Provision to focus only 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.[40]

*C. Significant Influence Test*

Furthermore, we believe that the current bright-line 10 percent test may be both over- and under-inclusive as a means of identifying those debtor-creditor relationships that actually impair the auditor's objectivity and impartiality. For example, the existing Loan Provision applies even in situations where the lender may be unable to influence the audit client through its holdings.[41] In such circumstances, the lender's ownership of an audit client's equity securities alone would not threaten an audit firm's objectivity and impartiality. Conversely, the existing Loan Provision does not apply if the auditor's lender owns 10 percent or less of the audit client's equity securities, despite the fact that such an owner could exert significant influence over the audit client through contractual or other means.[42] A holder of 10 percent or less of an audit client's equity securities could, for example, have the contractual right to remove or replace a pooled investment vehicle's investment adviser. Although other portions of Rule 2–01 of Regulation S–X apply, the Loan Provision's existing 10 percent bright-line test by itself would not capture this debtor-creditor relationship even though the relationship potentially raises questions about an auditor's objectivity and impartiality.[43]

We therefore propose to replace the existing 10 percent bright-line test in the Loan Provision with a ''significant influence'' test similar to that referenced in other parts of the Commission's auditor independence rules.[44] Specifically, the proposed amendment would provide that an accountant would not be independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client.[45]

We believe the proposed significant influence test would more effectively identify shareholders ''having a special and influential role with the issuer'' and therefore would better capture those debtor-creditor relationships that may impair an auditor's independence.[46] This test focuses on a lender shareholder's ability to influence the policies and management of an audit client, based on a totality of the facts and circumstances. While this analysis would include a consideration of the lender's beneficial ownership level in an audit client's equity securities, a bright-line percentage ownership of an audit client's securities alone would no longer determine an auditor's independence with respect to an audit client.

Specifically, under the ''significant influence'' test we are proposing today, an audit firm, together with its audit client, would be required to assess whether a lender (that is also a beneficial owner of the audit client's equity securities) has the ability to exert significant influence over the audit client's operating and financial policies.[47] Although not specifically defined, the term ''significant influence'' appears in other parts of Rule 2–01 of Regulation S–X,[48] and we intend to use the term ''significant influence'' in the proposed amendment to refer to the principles in the Financial Accounting Standards Board's (''FASB's'') ASC Topic 323, Investments—Equity Method and Joint Ventures.[49] The concept of ''significant influence'' has been part of the Commission's auditor independence rules since 2000 and has been part of the accounting standards since 1971.[50] Given its use in other parts of the Commission's independence rules,[51] the concept of ''significant influence'' is one with which audit firms and their clients are already required to be familiar. While audit firms and audit committees of operating companies already should be familiar with application of the ''significant influence'' concept, this concept is not as routinely applied today in the investment fund context for financial reporting purposes.[52] Nonetheless, the concept of significant

record owners, and as such, they may have low incentives to affect the report of the auditor. For example, record holders' discretion to vote the shares on behalf of their beneficial owners is typically limited. *See* the New York Stock Exchange (NYSE) Rule 452. The NYSE allows brokers to vote on certain items on behalf of their clients, if the broker has received no voting instructions from those clients within 10 days of the annual meeting. Brokers are only allowed to cast these discretionary votes on ''routine'' matters, which are generally uncontested and do not include a merger, consolidation, or any matter which may affect substantially the rights or privileges of such stock. Rule 452 lists the types of matters that brokers may not vote without customer instructions, which include executive compensation or uncontested elections of directors (other than uncontested director elections of companies registered under the Investment Company Act of 1940).

[39] An equity holder who acquired such ownership by buying a certificated share would be both a record owner and a beneficial owner and thus would continue to be analyzed under the Loan Provision.

[40] *See* 2000 Adopting Release, *supra* footnote 9.

[41] *Cf.* Accounting Standards Codification (''ASC'') 323, *infra* footnote 49 (providing examples where a holder may *not* have significant influence).

[42] *Cf.* ASC 323, *infra* footnote 49 (providing examples where a holder may have significant influence).

[43] *See supra* Section I.A for a discussion of the general standard under Rule 2–01(b) of Regulation S–X.

[44] *See* Rule 2–01(c)(1)(i)(E)(1)(i), (E)(1)(ii), (E)(2), (E)(3), (f)(4)(ii) and (f)(4)(iii) of Regulation S–X.

[45] *See* proposed Rule 2–01(c)(1)(ii)(A) (replacing the phrase ''record or beneficial owners of more than ten percent of the audit client's equity securities'' with ''beneficial owners (known through reasonable inquiry) of the audit client's equity securities, where such beneficial owner has significant influence over the audit client''). Under the proposed amendments, the rule would continue to have exceptions for four types of loans: (1) Automobile loans and leases collateralized by the automobile; (2) loans fully collateralized by the cash surrender value of an insurance policy; (3) loans fully collateralized by cash deposits at the same financial institution; and (4) a mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person. We discuss the proposed ''known through reasonable inquiry'' standard below. *See infra* section II.D.

[46] *See* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76035 (describing the 10 percent bright-line test as identifying shareholders ''having a special and influential role with the issuer'' that ''would be considered to be in a position to influence the policies and management of that client.'').

[47] *See* ASC 323, *infra* footnote 49. *See also infra* Section II.C for a discussion of an audit client's operating and financial policies in the fund context.

[48] *See* Rule 2–01(c)(1)(i)(E)(''investments in audit clients'') and Rule 2–01(f)(4) of Regulation S–X (''affiliate of the audit client'' definition).

[49] *See* ASC 323 Investments—Equity Method and Joint Ventures (''ASC 323''). *See* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76034, note 284 (referring to Accounting Principles Board Opinion No. 18, ''The Equity Method of Accounting for Investments in Common Stock'' (Mar. 1971), which was codified at ASC 323).

[50] *See* Accounting Principles Board (APB) Opinion No. 18 (March 1971) (''The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock.'').

[51] *See supra* footnote 44.

[52] *See* ASC 946. Financial Services—Investment Companies.

influence is applicable to funds under existing auditor independence rules.[53]

Under the proposed test, 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 under the existing accounting framework, 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.[54]

The lender's beneficial ownership of an audit client's equity securities also would be considered in determining whether a lender has significant influence over an audit client's operating and financial policies.[55] Unlike the existing Loan Provision, however, the significant influence test would not set a bright-line threshold above which a lender is assumed to be in a position to influence the policies and management of that client. Instead, the proposed significant influence test would be consistent with ASC 323 by establishing 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.[56] Conversely, and consistent with ASC 323, under the proposed significant influence test, if the ownership percentage were less than 20 percent, there would be a rebuttable presumption that the lender does not have significant influence over the audit client, unless it could be demonstrated that the lender has the ability to exert significant influence over the audit client.[57] Thus, significant influence could exist in circumstances where ownership is less than 20 percent.

ASC 323 lists several indicators that, as applied to the proposed significant influence test, would suggest a shareholder that owns 20 percent or more of the audit client's voting securities nonetheless may be unable to exercise significant influence over the operating and financial policies of the audit client, including the following:

• Opposition by the audit client, such as litigation or complaints to governmental regulatory authorities, challenging the shareholder's ability to exercise significant influence;

• An agreement (such as a standstill agreement) under which the shareholder surrenders significant rights as a shareholder;

• Majority ownership of the audit client is concentrated among a small group of shareholders who operate the audit client without regard to the views of the shareholder;

• The shareholder needs or wants more financial information than is available to other shareholders, tries to obtain that information, and fails;[58] and

• The shareholder tries and fails to obtain representation on the audit client's board of directors.[59]

In the fund context, we believe that the operating and financial policies relevant to the significant influence test would 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''). An audit firm could analyze whether significant influence over the fund's portfolio management processes exists 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, among any other relevant factors.

We believe that it would be appropriate to consider the nature of the services provided by the fund's investment adviser(s) pursuant to the terms of an advisory contract with the fund as part of this analysis. In circumstances where the terms of the advisory agreement grant the adviser significant discretion with respect to the fund's portfolio management processes and the shareholder does not have the ability to influence those portfolio management processes, significant influence generally would not exist. 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. On the other hand, if a shareholder in a private fund, for example, has a side letter agreement outside of the standard partnership agreement that allows for participation in portfolio management processes (including participation on a fund advisory committee), then the shareholder would likely have significant influence.

In circumstances where significant influence could exist, the audit firm would then evaluate whether an entity that is a beneficial owner of shares of a fund audit client has the ability to exercise significant influence over the fund and has a debtor-creditor relationship with the audit firm, any covered person in the firm, or any of his or her immediate family members.[60] If the auditor determines that significant influence does not exist based on the facts and circumstances at the time of the auditor's initial evaluation, we believe that the auditor should monitor the Loan Provision on an ongoing basis which could be done, for example, by reevaluating its determination when there is a material change in the fund's governance structure and governing documents, publicly available information about beneficial owners, or other information that may implicate the ability of a beneficial owner to exert significant influence of which the audit client or auditor becomes aware.

We believe that moving to a ''significant influence'' test would be advantageous. First, the ''significant influence'' test, which applies qualitative factors to broadly capture influence over an audit client, would be more effective in identifying lender shareholders that threaten an auditor's impartiality and independence than the current 10 percent bright-line test.

Second, the concept of ''significant influence'' already exists in the auditor independence rules and in ASC 323. For example, Rule 2–01(c)(1)(i)(E) of Regulation S–X, which generally governs investments in entities that invest in audit clients and investments in entities in which audit clients invest, requires the auditor to assess whether

[53] *See* Rule 2–01(c)(1)(i)(E)(1)(i), (E)(1)(ii), (E)(2), and (E)(3) of Regulation S–X.

[54] *See* ASC 323, *supra* footnote 49.

[55] The extent of a lender's ownership interest would be considered in relation to the concentration of other shareholders, but substantial or majority ownership of an audit client's voting stock by another shareholder would not necessarily preclude the ability to exercise significant influence by the lender. *See id.*

[56] ASC 323 contains a presumption that in the absence of predominant evidence to the contrary, an investor of 20% or more of the voting stock has the ability to exercise significant influence over the investee. *See* ASC 323–10–15–8. *See also* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76034, note 497 and accompanying text.

[57] Under ASC 323, an investment of less than 20% of the voting stock shall lead to the presumption that an investor does not have the ability to exercise significant influence over the investee unless such ability can be demonstrated. *See* ASC 323–10–15–8.

[58] We recognize that there may be reasons other than a lack of influence—such as concerns under Regulation FD or the antifraud provisions of the federal securities laws generally—that might result in an issuer declining to provide financial information to a shareholder.

[59] *See* ASC 323–10–15–10.

[60] *See infra* Part II.D for a discussion of the proposed ''known through reasonable inquiry'' standard.

investments are material and whether the investment results in the ability to exercise significant influence over that entity.[61] Similarly, the ''affiliate of the audit client'' definition in the auditor independence rules requires that a determination be made as to whether there are entities over which the audit client has significant influence (unless the entity is not material to the audit client) or any entities that have significant influence over the audit client (unless the audit client is not material to the entity).[62] The parties that would be tasked with implementing a ''significant influence'' test in the Loan Provision—accounting firms, issuers and their audit committees—thus are already required to be familiar with this concept under the auditor independence rules. We believe that these entities likely would be able to leverage any existing practices, processes and controls for determining significant influence to comply with the proposed changes to the Loan Provision.

*D. Reasonable Inquiry Compliance Threshold*

As described above, another challenge in the application of the current Loan Provision involves the difficulty in accessing information regarding the ownership percentage of an audit client for the purposes of the current 10 percent bright-line test. For example, the shares of closed-end funds are commonly held of record by broker-dealers, which may be reluctant to share information about the underlying beneficial owners. In addition, also as indicated above, institutions may be the holder of record of shares in an audit client merely as custodian or as an omnibus account holder, adding a layer, and in some cases multiple layers, of complexity to obtaining information about the underlying beneficial ownership. Moreover, a beneficial owner may object to disclosure of its name, address, and securities position to the issuer, so that issuers may be unable to obtain the beneficial ownership information for these owners.[63]

We therefore propose to amend the Loan Provision to address the concerns about accessibility to records or other information about beneficial ownership by adding a ''known through reasonable inquiry'' standard with respect to the identification of such owners. Under this proposed amendment, an audit firm, in coordination with its audit client, would be required to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry. We believe that 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, including because that lender invests in the audit client indirectly through one or more financial intermediaries, the auditor's objectivity and impartiality is unlikely to be impacted by its debtor-creditor relationship with the lender. This ''known through reasonable inquiry'' standard is generally consistent with regulations implementing the Investment Company Act, the Securities Act and the Exchange Act,[64] and therefore is a concept that already should be familiar to those charged with compliance with the provision.

*E. Excluding Other Funds That Would Be Considered Affiliates of the Audit Client*

The current definition of ''audit client'' in Rule 2–01 of Regulation S–X includes all ''affiliates of the audit client,'' which broadly encompasses, among others, each entity in an ICC of which the audit client is a part. In the fund context, this expansive definition of ''audit client'' could result in non-compliance with the Loan Provision as to a broad range of entities, even where an auditor does not audit that entity.[65] Yet, in the investment management context, investors in a fund typically do not possess the ability to influence the policies or management of another fund in the same fund complex. Although an investor in one fund in a series company can vote on matters put to shareholders of the company as a whole, rather than only to shareholders of one particular series, even an investor with a substantial investment in one series would be unlikely to have a controlling percentage of voting power of the company as a whole.

Moreover, for the purposes of the Loan Provision, 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.[66] Indeed, auditors often have little transparency into the investors of other funds in an ICC (unless they also audit those funds), and

[61] *See* 2000 Adopting Release, *supra* footnote 9, at 65 FR 76034. Rule 2–01(c)(1)(i)(E) of Regulation S–X contains several provisions that use a materiality qualifier. For example, an accountant would not be independent if it ''[h]as any material investment in an entity over which an audit client has the ability to exercise significant influence. . . .'' *See* Rule 2–01(c)(1)(i)(E)(2) of Regulation S–X. Rule 2–01(c)(1)(i)(E) of Regulation S–X also contains a significant influence provision without a materiality qualifier, in which an accountant would not be independent of its audit client when the accountant ''[h]as the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.'' *See* Rule 2–01(c)(1)(i)(E)(3) of Regulation S–X.

[62] *See* Rule 2–01(f)(4) of Regulation S–X.

[63] Pursuant to Rule 14a–13(b) under the Exchange Act, an issuer may obtain from broker-dealers and banks a list of the names, addresses and securities positions of only the beneficial owners who either have consented or have not objected to having such information provided to issuers. *See* 17 CFR 240.14a–13(b).

[64] *See, e.g.,* Rule 3b–4 under the Exchange Act (stating, with respect to the definition of foreign private issuer, that ''[i]f, after reasonable inquiry, you are unable to obtain information about the amount of shares represented by accounts of customers resident in the United States, you may assume, for purposes of this definition, that the customers are residents of the jurisdiction in which the nominee has its principal place of business.); Rule 144(g) under the Securities Act (noting, with respect to ''brokers' transactions'' that ''[t]he term brokers' transactions in section 4(4) of the [Securities] Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker: . . . (4) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer''); Rule 502(d) under the Securities Act (stating, with respect to limits on resales under Regulation D, that ''[t]he issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the [Securities] Act, which reasonable care may be demonstrated by the following: (1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons''). Registered investment companies also are subject to a similar requirement to disclose certain known beneficial owners. *See* Item 18 of Form N–1A (''State the name, address, and percentage of ownership of each person who owns of record or is known by the Fund to own beneficially 5% or more of any Class of the Fund's outstanding equity securities.''); and Item 19 of Form N–2 (''State the name, address, and percentage of ownership of each person who owns of record or is known by the Registrant to own of record or beneficially five percent or more of any class of the Registrant's outstanding equity securities.'').

[65] For example, under the current Loan Provision, an audit firm (''Audit Firm B'') could be deemed not to be independent as to an audit client under the following facts: Audit Firm A audits an investment company (''Fund A'') for purposes of the Custody Rule. A global bank (''Bank'') has a greater than 10 percent interest in Fund A. Bank is a lender to a separate Audit Firm B, but has no lending relationship with Audit Firm A. Audit Firm B audits another investment company (''Fund B'') that is part of the same ICC as Fund A because it is advised by the same registered investment adviser as Fund A. Under these facts, Audit Firm B would not be independent under the existing Loan Provision because the entire ICC would be tainted as a result of Bank's investment relationship with Fund A.

[66] *See* 2000 Adopting Release, *supra* footnote 9, at 76035 (The Commission, in adopting an ownership threshold of 10 percent, rather than the five percent proposed, stated that ''[w]e have made this change because we believe that doing so will not make the rule significantly less effective, and may significantly increase the ease with which one can obtain the information necessary to assure compliance with this rule.'').

therefore, are likely to have little ability to collect such beneficial ownership information.

As a result, we propose, for purposes of the Loan Provision, to exclude from the definition of audit client, for a fund under audit, any other fund that otherwise would be considered an affiliate of the audit client.[67] Thus, for example, if an auditor were auditing Fund ABC, a series in Trust XYZ, the audit client for purposes of the Loan Provision would exclude all other series in Trust XYZ and any other fund that otherwise would be considered an affiliate of the audit client. The proposed amendment would, without implicating an auditor's objectivity and impartiality, address the compliance challenges associated with the application of the Loan Provision where the audit client is part of an ICC, such as when an accountant is an auditor of only one fund within an ICC, and the auditor must be independent of every other fund (and other entity) within the ICC, regardless of whether the auditor audits that fund.

## III. Request for Comment

We request and encourage any interested person to submit comments on any aspect of our proposed amendments, other matters that might have an effect on the proposed amendments, and any suggestions for additional changes to other parts of Rule 2–01 of Regulation S–X. We note that comments are of greatest assistance where accompanied by supporting data and analysis of the issues addressed in those comments.

We also specifically seek comment on the following changes to the Loan Provision:

### *1. Focus the Analysis Solely on Beneficial Ownership*

- Should the Loan Provision be analyzed by reference to beneficial owners rather than record owners? Why or why not?
- Would eliminating the requirement to analyze record owners under the Loan Provision ease compliance challenges described above under Section 1.B.? Is there any further guidance the Commission should provide, or should the Commission consider alternatives?
- Would eliminating the requirement to analyze record owners under the Loan Provision raise other concerns about the independence of auditors? If so, what concerns would it raise and why?
- If the Commission merely amended the Loan Provision to provide for evaluation of the beneficial owner, rather than record owner, would other proposed amendments be necessary or appropriate? Why or why not?

### *2. "Significant Influence" Test*

- Should we amend the Loan Provision to replace the 10 percent bright-line test with a "significant influence" test? Why or why not?
- Would the proposed reference to ASC's 323's provisions for "significant influence" effectively identify those lending relationships that may compromise auditor independence?
- Would amending the Loan Provision to replace the 10 percent bright-line test with a "significant influence" test, along with the other proposed amendments, address the compliance challenges that we identify above?
- Application of "significant influence" for financial reporting purposes and evaluation of auditor independence may not necessarily be congruent. Accordingly, does ASC 323—Investments—Equity Method and Joint Ventures, provide an appropriate framework for analyzing "significant influence" in the context of the Loan Provision? Why or why not?
- Are there challenges associated with implementing the "significant influence" test that we should consider? Will accounting firms' and audit clients' relative experience with application of the "significant influence" test, given its use in other contexts, mitigate any such challenges? To what extent do audit clients lack experience with application of the significant influence test, and what costs would such audit clients bear in learning to apply the test? Will funds, which may have relatively less experience than operating companies with the significant influence test, face any particular challenges in applying the test?
- Is the proposed "significant influence" test sufficiently clear? Are there specific circumstances for which we should provide additional guidance? For example, we discuss above the application of the significant influence test in the fund context. Is the guidance sufficiently clear? Would the application of the significant influence test as applied to funds be effective in addressing the compliance challenges generated by the current Loan Provision while also identifying debtor-creditor relationships that may bear on an auditor's independence with respect to a fund client? Why or why not? Is there further guidance that we should provide or other approaches that we should consider?
- Should the "significant influence" test (or specific elements) be codified in our rules? Why or why not?
- Authorized participants ("APs") for ETFs deposit or receive basket assets in exchange for creation units of the fund. We believe that the deposit or receipt of basket assets by an AP that is also a lender to the auditor alone would not constitute significant influence over an ETF audit client. Should we provide additional guidance about the proposed "significant influence" test with respect to APs? Similarly, should we provide additional guidance about the proposed "significant influence" test with respect to a market maker that is also a lender to the auditor and that engages an AP on an agency basis to create or redeem creation units of the ETF on its behalf?
- ASC 323 includes a rebuttable presumption of 20 percent. For purposes of the Loan Provision and the proposed significant influence test, should the rebuttable presumption be lower or higher than 20 percent? Would a lower threshold (*e.g.,* 10 percent) be more likely to capture relevant independence-impairing relationships, or to result in additional false positives that the proposed rule seeks to avoid? Would setting our threshold differently than ASC 323 diminish the benefits that we seek to achieve by using an existing standard—*e.g.,* by requiring the reperformance of certain analyses at a greater degree of sensitivity? How much more complex would it be to apply a threshold other than 20 percent? Are there further relevant facts about a lower or higher threshold that we should consider?
- Would the proposed amendment raise any new concerns regarding auditor independence (*e.g.,* are there circumstances related to lending relationships in which an auditor's independence should be considered impaired that would not be identified under the proposed "significant influence" test)? Conversely, would the proposed "significant influence" test result in an auditor's independence being considered impaired in circumstances under which the auditor should otherwise be considered independent?
- Should we consider alternatives to this test? If so, what tests should we consider, and what would be the anticipated costs and benefits? For example, should the modifier

[67] *See* proposed Rule 2–01(c)(1)(ii)(A)(2) of Regulation S–X: "For purposes of paragraph (c)(1)(ii)(A) of this section, the term *audit client* for a fund under audit excludes any other fund that otherwise would be considered an *affiliate of the audit client.* The term *fund* means 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 of 1940 (15 U.S.C. 80a–3(c))."

''significant'' be removed, such that the test hinges on whether a lender shareholder has influence over an audit client? Why or why not? What is the difference between ''influence'' and ''significant influence'' in the auditor independent context and how does that difference inform the test?

○ Should the nature of the services provided by the investment adviser be part of the significant influence test as proposed? Why or why not?

*3. ''Known Through Reasonable Inquiry''*

○ Should the Loan Provision include a ''known through reasonable inquiry'' standard? Why or why not? What alternatives should we consider?

○ Would the proposed ''known through reasonable inquiry'' standard with respect to identifying beneficial owners help to address compliance challenges associated with the Loan Provision?

○ Are there specific circumstances for which we should provide additional guidance about the proposed ''known through reasonable inquiry'' standard?

○ Does the ''known through reasonable inquiry'' standard raise any new concerns regarding auditor independence (*e.g.,* are there circumstances related to lending relationships in which an auditor's independence should be considered impaired that would not be identified under the proposed amendment and the use of ''known through reasonable inquiry'' standard)?

○ Alternatively, should we amend the Loan Provision to apply the significant influence test to ''known beneficial owners'' of an audit client's equity securities, without also including a reasonable inquiry standard, consistent with the way beneficial owners are treated elsewhere in Regulation S–X (that is, when assessing compliance with the Loan Provision, the determination would encompass assessing whether the known beneficial owners have significant influence over the audit client)? [68]

*4. Proposed Amendment To Exclude From ''Audit Client'' Other Funds That Would Be Considered an ''Affiliate of the Audit Client''*

○ Should affiliates of an audit client be excluded from the definition of ''audit client'' as it relates to the Loan Provision? Why or why not?

○ Would the proposed amendment to exclude from the term ''audit client'' for a fund under audit any other fund that otherwise would be considered an ''affiliate of the audit client'' address compliance challenges associated with the Loan Provision while still effectively identifying lending relationships that may impair auditor independence?

○ Would the proposed amendment appropriately exclude funds of an ''investment company complex'' (other than the fund under audit) that are currently within the Loan Provision's ambit?

○ Alternatively, are there other changes we should consider to the Loan Provision to appropriately exclude certain affiliated funds?

In addition to any comments regarding the proposed amendments, we also seek comment on the following potential changes to the Loan Provision and to other provisions in Rule 2–01 that we considered but determined not to propose at this time.

A. Materiality

The proposed amendments to the Loan Provision do not consider whether the lender's investment in the equity securities of the audit client is material to the lender or to the audit client.[69] We believe that adding a materiality qualifier to the proposed significant influence test is unnecessary to achieve our goal of effectively and appropriately identifying lending relationships that could pose threats to auditor independence. Nevertheless, we request comment on whether there should be a materiality qualifier as part of the Loan Provision.

○ For example, should we include a provision for assessing materiality in the Loan Provision such that an auditor's independence would only be impaired as a result of certain relationships where the lender to the auditing firm has beneficial ownership in the audit client's equity securities and that investment is material to the lender or to the audit client (and the lender has the ability to exercise significant influence over the audit client)? Would that approach more effectively identify lending relationships that are likely to threaten the auditor's objectivity and impartiality? Would focusing on the perspective of the lender, the audit client, or both be the most effective barometer of independence?

○ If we were to add a materiality qualifier to the Loan Provision as described above, which qualitative and quantitative factors should be considered in making the materiality assessment? Would such a materiality assessment add unnecessary complexity to the significant influence analysis? Would a materiality qualifier tend to exclude most lending relationships from the Loan Provision? What guidance, if any, should the Commission provide?

B. Accounting Firms' ''Covered Persons'' and Immediate Family Members

The Loan Provision is implicated with respect to loans both to and from an accounting firm, and also any ''covered person'' in the firm or any of his or her immediate family members.[70] Some of the consultations the Commission staff have had with audit firms, funds, and operating companies involved lending relationships to or from covered persons or their immediate family members.

○ Should we amend the definition of ''covered person'' for purposes of the Loan Provision or elsewhere in the auditor independence rules, and if so, how should the definition of ''covered person'' be amended?

○ In particular, taking into account the proposed ''significant influence'' test, should we, for example, remove or revise the part of the current definition that includes any partner, principal, or shareholder from an ''office'' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit? Should all of these persons practicing out of an office from which an audit is conducted be included? Should immediate family members be removed from the definition? Why or why not?

○ In addition, the Loan Provision provides that it does not apply to certain loans made by a financial institution under its normal lending procedures, terms, and requirements, such as automobile loans and leases

[68] Under Rule 1–02(r) of Regulation S–X, ''principal holder of equity securities,'' when used in respect of a registrant or other person named in a particular statement or report, is defined to mean: ''a holder of record or a *known* beneficial owner of more than 10 percent of any class of equity securities of the registrant or other person, respectively, as of the date of the related balance sheet filed.'' (emphasis added). This approach also would be consistent with the disclosure requirements for registered funds, which require a fund to disclose information about known beneficial owners of five percent or more of the fund's securities. *See* Item 18 of Form N–1A (''State the name, address, and percentage of ownership of each person who owns of record or is known by the Fund to own beneficially 5% or more of any Class of the Fund's outstanding equity securities.''); and Item 19 of Form N–2 (''State the name, address, and percentage of ownership of each person who owns of record or is known by the Registrant to own of record or beneficially five percent or more of any class of the Registrant's outstanding equity securities.'').

[69] Certain other provisions of the existing auditor independence rules utilize a materiality qualifier. For example, an accountant is deemed not to be independent if the accountant has ''any direct financial interest or *material* indirect financial interest in the accountant's audit client.'' *See* Rule 2–01(c)(1) of Regulation S–X. (emphasis added)

[70] *See* Rule 2–01(c)(1)(ii)(A) and (f)(11) of Regulation S–X.

collateralized by the automobile. Should we consider expanding or otherwise modifying the specific types of loans that will not implicate the Loan Provision, given that the Loan Provision applies to covered persons of the accounting firm and their immediate family members? For example, should the Loan Provision address student loans or partner capital account loans? If so, how should it address them? For example, should it exclude them altogether or exclude them under certain conditions? If so, under what conditions?

C. Evaluation of Compliance

Rule 2–01(c)(1) of Regulation S–X provides that an accountant is not independent if the accountant has an independence-impairing relationship specified in the rule at any point during the audit and professional engagement period. Some existing disclosure requirements require information about beneficial owners as of a specified date.[71]

◦ Should the rule provide that auditor independence may be assessed in reliance on such disclosures? Should we make any changes related to the frequency with which, the date as of which, or circumstances under which, an auditor must assess compliance with the Loan Provision or other provisions of Rule 2–01 of Regulation S–X? More specifically, should we permit the Loan Provision or other financial relationships to be assessed at specific dates during the audit and professional engagement period, or the beginnings or ends of specific periods, or under specified circumstances? If so, what would be appropriate dates, periods, or circumstances?

We believe that if the auditor determines that significant influence over the fund's management processes could not exist,[72] the auditor could monitor its independence on an ongoing basis 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.

◦ Would this approach be sufficient for evaluating compliance with the Loan Provision? Why or why not?

D. Secondary Market Purchases of Debt

The existing Loan Provision encompasses lending arrangements that may change depending upon secondary market purchases of syndicated or other debt. For example, audit firms may issue private placement notes for financing purposes, which could then be sold on the secondary market to new purchasers thereby creating new lending relationships between the audit firm and these new secondary market purchasers.

◦ Should such secondary market relationships be taken into account or excluded from the Loan Provision? Do secondary market relationships raise concerns about auditor independence?

E. Other Changes to the Commission's Auditor Independence Rules

◦ Should we make other changes to our auditor independence rules? If so, which rules and why?

◦ Would our proposed amendments have any unintended impact on other professional standards that may exist, such as the requirements of the PCAOB, professional societies, or state boards of accountancy?

## IV. Paperwork Reduction Act

The amendments we are proposing do not impose any new ''collections of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA''),[73] nor do they create any new filing, reporting, recordkeeping, or disclosure requirements. Accordingly, we are not submitting the proposed amendments to the Office of Management and Budget for review in accordance with the PRA.[74] We request comment on whether our conclusion that there are no collections of information is correct.

## V. Economic Analysis

The Commission is proposing to amend the Loan Provision in Rule 2–01 of Regulation S–X by: (1) Focusing the analysis solely on beneficial ownership; (2) replacing the existing 10 percent bright-line equity shareholder ownership test with a ''significant influence'' test; (3) adding a ''known through reasonable inquiry'' standard with respect to identifying beneficial owners of the audit client's equity securities; and (4) amending the definition of ''audit client'' for a fund under audit to exclude from the provision funds that otherwise would be considered affiliates of the audit client.

Under existing rules, the bright-line test does not recognize an accountant as independent if the accounting firm, any covered person in the firm, or 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 percent of the audit client's equity securities. In terms of the scope of the ''audit client'' definition, the existing rule is generally broad, including as it relates to an audit client in an ICC.[75] As discussed above, Commission staff has engaged in extensive consultations with audit firms, funds, and operating companies regarding the application of the Loan Provision. These consultations revealed that a number of entities face significant practical challenges to compliance with the Loan Provision. These discussions also revealed that in certain scenarios, in which the Loan Provision was implicated, the auditor's objectivity and impartiality in performing the required audit and interim reviews were not impaired.

We are mindful of the costs imposed by and the benefits obtained from our rules and amendments.[76] The following economic analysis seeks to identify and consider the likely benefits and costs that would result from the proposed amendments, including their effects on efficiency, competition, and capital formation. The discussion below elaborates on the likely economic effects of the proposed rules.

### *A. General Economic Considerations*

Given that the actions of fund and operating company management are not usually observable, the information contained in mandated financial reports is important to investors, because it serves as a summary measure of outcomes of managerial actions and

[71] *See e.g.,* Item 18 of Form N–1A and Item 19 of Form N–2.

[72] For funds, the auditor's initial determination would be based on an evaluation of a fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements, among any other relevant factors.

[73] 44 U.S.C. 3501 *et. seq.*

[74] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[75] *See supra* footnote 16 and accompanying text.

[76] Section 2(b) of the Securities Act [15 U.S.C. 77b(b)], Section 3(f) of the Exchange Act [17 U.S.C. 78c(f)], Section 2(c) of the Investment Company Act [15 U.S.C. 80a–2(c)], and Section 202(c) of the Investment Advisers Act [15 U.S.C. 80b–2(c)] require the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. Additionally, Section 23(a)(2) of the Exchange Act [15 U.S.C. 78w(a)(2)] requires us, when adopting rules under the Exchange Act, to consider, among other things, the impact that any new rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act.

decisions.[77] However, financial reports are prepared by agents, and given the possibility that agents may have incentives to take actions that are not in the best interest of shareholders, agents may also have incentives to misreport such decisions and their outcomes. In order for the reported information to be useful to investors, it needs to be relevant and reliable. The independent audit of such information by impartial skilled professionals (*i.e.,* auditors) is intended to create reliability in financial reports.[78] Any potential conflicts of interest between companies or funds and their auditors may impair the objectivity and impartiality of the auditors in certifying the reported performance, thus lowering the credibility and usefulness of these disclosures to investors. Academic literature discusses and documents the importance of the role of auditors as an external governance mechanism for the firm.[79] These studies generally find that better audit quality improves financial reporting by increasing the credibility of the financial reports.

An accounting firm is not independent under the Loan Provision's existing bright-line shareholder ownership test if the firm 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 ''affiliate of the audit client,'' including, but not limited to, 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. The magnitude of a party's investment in a company or fund is likely to be positively related with any incentive of that party to use leverage over the auditor with whom the party has a lending relationship, to obtain personal gain.

The 10 percent bright-line test in the Loan Provision does not, however, distinguish between holders of record and beneficial owners even though beneficial owners are more likely to pose a risk to auditor independence than record owners given that the financial gain of beneficial owners is tied to the performance of their investment, and as such, beneficial owners may have strong incentives to influence the auditor's report. Record owners, on the other hand, may not benefit from the performance of securities of which they are record owners, and as such, they may have low incentives to influence the report of the auditor. Both the magnitude as well as the type of ownership are likely to be relevant factors in determining whether incentives exist for actions that could impair auditor independence. Beneficial ownership of more than 10 percent of a company's or fund's equity securities by a lender to the company's or fund's auditor is likely to pose a more significant risk to auditor independence than record ownership of more than 10 percent of the company's or fund's securities by the same lender.

The current Loan Provision may in some cases over-identify and in other cases under-identify threats to auditor independence. The likelihood that the provision over-identifies threats to auditor independence will tend to be higher when the lender is not a beneficial owner of an audit client and does not have incentives to influence the auditor's report, but has record holdings that exceed the 10 percent ownership threshold. On the other hand, under-identification of the threat to auditor independence may occur when the lender is a beneficial owner—implying the existence of potential incentives to influence the auditor's report—and the investment is close to, but does not exceed, the 10 percent ownership threshold.[80]

We are not aware of academic studies that specifically examine the economic effects of the Loan Provision. The remainder of the economic analysis presents the baseline, anticipated benefits and costs from the proposed amendments, potential effects on efficiency, competition and capital formation, and alternatives to the proposed amendments.

### *B. Baseline*

The proposed amendments would change the Loan Provision compliance requirements for the universe of affected registrants. We believe the main affected parties would be audit clients, audit firms, and institutions engaging in financing transactions with audit firms and their partners and employees. Other parties that may be affected are covered persons and their immediate family members. Indirectly, the proposed amendment would affect audit clients' investors.

We are not able to precisely estimate the number of current auditor engagements that would be immediately affected by the proposed amendments. Specifically, precise data on how audit firms finance their operations and how covered persons arrange their personal financing are not available to us and as such we are not able to identify pairs of auditors-institutions (lenders). Moreover, sufficiently detailed and complete data on fund ownership are not available to us, thus limiting our ability to estimate the prevalence/frequency of instances of significant fund ownership by institutions that are also lenders to fund auditors.

Although data on fund ownership are not readily available, academic studies of operating companies have shown that for a selected sample of firms, the average blockholder (defined as beneficial owners of five percent or more of a company's stock) holds about 8.5percent of a company's voting stock.[81] They also show that numerous banks and insurance companies are included in the list of blockholders. These findings suggest that the prevalence of instances of significant ownership by institutions that are also lenders to auditors could be high.

As mentioned above, the proposed amendments would impact audits for the universe of affected entities. The baseline analysis below focuses mainly on the investment management industry because that is where the most widespread issues with Loan Provision compliance have been identified to date; however, the proposed amendments would affect entities outside of this space.[82]

In Table 1, as of December 2017, there were around 12,000 fund series, with total net assets of $21 trillion, that file Form N–SAR with identified accounting firms.[83] In addition, there were 23

[77] We use the terms agent and manager interchangeably.

[78] *See* M. Defond & J. Zhang, *A Review of Archival Auditing Research,* 58 J. Acct. & Econ. 275–326 (2014).

[79] *See e.g.,* N. Tepalagul & L. Lin, *Auditor Independence and Audit Quality: A Literature Review,* 30 J. Acct. Audit. & Fin. 101–121 (2015); M. Defond & J. Zhang, *A Review of Archival Auditing Research,* 58 J. Acct. & Econ. 275–326 (2014); Y. Chen, S. Sadique, B. Srinidhi, & M. Veeraraghavan, *Does High-Quality Auditing Mitigate or Encourage Private Information Collection?;* and R. Ball, S. Jayaraman & L. Shivakumar, *Audited Financial Reporting and Voluntary Disclosure as Complements: A Test of the Confirmation Hypothesis,* J. Acct. & Econ. 53(1): 136–166 (2012).

[80] We are unable to estimate the extent to which the 10 percent ownership threshold may over- or under-identify threats to independence because public data do not exist.

[81] *See* Y. Dou, O. Hope, W. Thomas & Y. Zou, *Blockholder Heterogeneity and Financial Reporting Quality,* working paper (2013).

[82] According to the SEC's EDGAR database, during the period from January 1, 2017 to December 31, 2017, there were a total of 7,585 entities that filed at least one Form 10–K, 20–F, or 40–F, or an amendment to one of these forms. This total does not include investment companies and business development companies.

[83] There are certain limitations regarding information reported on Form N–SAR and, as a result, this does not include information for all registered investment companies. If we were to incorporate private funds, the number would be

accounting firms performing audits for these investment companies, though these auditing services were concentrated among the four largest accounting firms. Indeed, about 88 percent of the funds were audited by the four largest accounting firms, corresponding to 98percent of the aggregate fund asset value.[84]

TABLE 1—INVESTMENT COMPANY AUDITORS AND THEIR AUDITED FUND SERIES

[N–SARs filed for period dates: June 2017–December 2017]

| | |
|---|---|
| Total number of Fund Series | 11,666 |
| Average number of Fund Series Per Auditor | 507 |
| Average Net Assets (in millions) Per Auditor | 907,813 |
| Four Largest Audit Firms | |
| Total number of Fund Series | 10,177 |
| Average number of Fund Series Per Auditor | 2,544 |
| Average Net Assets (in millions) Per Auditor | 5,137,472 |
| % of Four Audit Firms by Series | 87 |
| % of Four Audit Firms by Net Assets | 98 |

One key feature of the current rule is that the scope of the auditor independence rules, including the Loan Provision, extends beyond the audit client to encompass affiliates of the audit client. According to Morningstar Direct, as of December 31, 2017, 586 out of 977 fund families[85] (excluding closed-end funds) have more than one fund, 180 have at least 10 funds, 59 have more than 50 funds, and 38 have more than 100 funds. According to the Investment Company Institute, also as of December 31, 2017, there were more than 11,188 open-end funds and around 5,500 closed-end funds, with many funds belonging to the same fund family. Given that many fund complexes have several funds with some complexes having several hundreds of funds, if any auditor is deemed not in compliance with the Loan Provision with respect to one fund, under the current rule it cannot audit any of the hundreds of other funds within the same ICC.

In response to compliance challenges and as discussed above, Commission staff issued the Fidelity No-Action Letter to provide relief from the uncertainty surrounding compliance with the Loan Provision. The Fidelity No-Action Letter, however, did not resolve all compliance uncertainty, was limited in scope and provided staff-level relief to the requestor based on the specific facts and circumstances in the request, and did not amend the underlying rule. Staff continues to receive inquiries from registrants and accounting firms regarding the application of the Loan Provision, clarification of the application of the Fidelity No-Action Letter, and requests for consultation regarding issues not covered in the Fidelity No-Action Letter. As a result of the remaining compliance uncertainty, auditors and audit committees may spend a significant amount of time and effort to comply with the Loan Provision.

*C. Anticipated Benefits and Costs, and Unintended Consequences*

1. Anticipated Benefits

Overall, we anticipate monitoring for non-compliance throughout the reporting period would be less burdensome for registrants under the proposed amendments. For example, based on the 10 percent bright-line test, an auditor may be in compliance at the beginning of the reporting period. However, the percentage of ownership may change during the reporting period, which may result in an auditor becoming non-compliant, even though there may be no threat to the auditor's objectivity or impartiality. Further, a higher threshold (20 percent) for presumed significant influence, as well as a qualitative framework for assessing what constitutes significant influence, could better identify a lack of independence.

There are also potential benefits associated with excluding record holders from the Loan Provision. Currently, the Loan Provision uses the magnitude of ownership by an auditor's lender as an indication of the likelihood of a threat to auditor independence regardless of the nature of ownership. From an economic standpoint, the nature of ownership also could determine whether incentives as well as the ability of the lender to use any leverage (due to the lending relationship) over the auditor exist that could affect the objectivity of the auditor. For example, a lender that is a record owner of the audit client's equity securities may be less likely to attempt to influence the auditor's report than a lender that is a beneficial owner of the audit client's equity securities. By taking into account the nature as well as the magnitude of ownership, the proposed amendments would focus on additional qualitative information to assess the relationship between the lender and the investee (*e.g.,* a company or fund). Thus, we believe that, where there may be weak incentives by the lender to influence the audit, as when the lender is only a holder of record, the proposed amendments would exclude relationships that are not likely to be a risk to auditor independence. The proposed amendments would thus provide benefits to the extent that they would alleviate compliance and related burdens that auditors and funds would otherwise undertake to analyze debtor-creditor relationships that are not likely to threaten an auditor's objectivity and impartiality. Affected registrants also would be less likely to disqualify auditors in situations that do not pose a risk to auditor independence, thereby reducing auditor search costs for these entities.

The potential expansion of the pool of eligible auditors also could result in better matching between the auditor and the client. For example, auditors tend to exhibit a degree of specialization in certain industries.[86] If specialized auditors are considered not to be independent due to the Loan Provision, then an auditor without the relevant specialization may be selected by companies to perform the audit. Such an outcome could impact the quality of the audit, and as a consequence negatively impact the quality of financial reporting, and therefore the users of information contained in audited financial reports. In addition, this outcome also may lead to less specialized auditors expending more time to perform the audit service, thereby increasing audit fees for registrants. We anticipate that the proposed amendments likely would positively impact audit quality for scenarios such as the one described above. Relatedly, if the proposed amendments expand the pool of eligible auditors, we expect increased competition among auditors, which could reduce the cost of audit services

significantly larger; the assets under management of private funds are also large.

[84] According to the 2017 PCAOB Annual Report, there were 535 audit firms registered with the PCAOB that have issued audit reports for issuers (of which 338 are domestic audit firms, with the remaining 197 audit firms located outside the United States). The concentration in the provision of audit services for investment companies is indicative of the overall market as well. According to a report by Audit Analytics, the four largest accounting firms audit 76% of accelerated and large accelerated filers, which account for 97.9% of the market capitalization for public companies. *See Who Audits Larger Public Companies-2016 Edition, available at http://www.auditanalytics.com/blog/who-audits-larger-public-companies-2016-edition.*

[85] These fund statistics are based on information available from Morningstar Direct, and may not represent the universe of fund companies.

[86] *See e.g.,* N. Dopuch & D. Simunic, *Symposium, Competition in Auditing: An Assessment,* Fourth Symposium on Auditing Research, p 401–450 (1982); and R.W. Knechel, V. Naiker & G. Pachecho, *Does Audit Industry Specialization Matter? Evidence from Market Reaction to Auditor Switches,* 26 Audit. J. Prac. & Theory 19–45 (2007).

to affected companies and, if such cost savings are passed through to investors, could result in a lower cost to investors. However, as discussed in Section V.B above, the audit industry is highly concentrated, and as a consequence, such a benefit may not be significant.[87]

Another potential benefit of the proposed amendments is that the replacement of the bright-line test with the significant influence test could potentially identify risks to auditor independence that might not have been identified under the existing 10 percent bright-line test. For example, a beneficial owner that holds slightly less than 10 percent of an audit client's equity securities is likely to have similar incentives and ability to influence the auditor's report than a beneficial owner that holds the same audit client's equity securities at slightly above the 10 percent threshold. The existing Loan Provision itself would differentially classify these two hypothetical situations, despite their similarity. To the extent that the proposed amendments are able to improve identification of potential risks to auditor independence through the use of qualitative criteria, then investors are likely to benefit from the proposed amendments. In the example above, under the proposed amendments, an audit firm would evaluate both beneficial owners to determine if they have significant influence, thus providing a consistent analysis under the Loan Provision for these economically similar fact patterns.

In addition, there may be instances in which non-compliance with the Loan Provision may occur during the reporting year, after an auditor is selected by the registrant or fund. Particularly for companies in the investment management industry, an auditor may be deemed to comply with the Loan Provision using the bright-line test when the auditor is hired by the fund but, due to external factors, such as redemption of investments by other owners of the fund during the period, the lender's ownership level may increase and exceed 10 percent. Such outcomes would be less likely under the proposed amendments, which take into account multiple qualitative factors in determining whether the Loan Provision is implicated during the period.[88] We anticipate that the proposed amendments would likely mitigate changes in auditors' independence status and mitigate any negative consequences that can arise from uncertainty about compliance and the associated costs to the funds or companies involved and their investors.

The proposed amendment to add a ''known through reasonable inquiry'' standard could potentially improve the practical application of the significant influence test. As described above, some of the challenges to compliance with the existing Loan Provision involve the lack of access to information about the ownership percentage of a fund that was also an audit client. If an auditor does not know that one of its lenders is also an investor in an audit client, including because that lender invests in the audit client indirectly through one or more financial intermediaries, the auditor's objectivity and impartiality may be less likely to be impacted by its debtor-creditor relationship with the lender. The proposed ''known through reasonable inquiry'' standard is generally consistent with regulations implementing the Investment Company Act, the Securities Act and the Exchange Act,[89] and therefore is a concept that already should be familiar to those charged with compliance with the provision. The proposed standard is expected to reduce the compliance costs for audit firms as they could significantly reduce their search costs for information and data to determine beneficial ownership. Given that this would not be a new standard in the Commission's regulatory regime, we do not expect a significant adjustment to apply the ''known through reasonable inquiry'' standard for auditors and their audit clients.

The proposal to amend the definition of ''audit client'' to exclude any fund not under audit but that otherwise would be considered an ''affiliate of the audit client'' could potentially lead to a larger pool of eligible auditors, potentially reducing the costs of switching auditors, and potentially creating better matches between auditors and clients. In addition, the larger set of potentially eligible auditors could lead to an increase in competition among auditors for clients, and improved matching between auditor specialization and client needs. Though the concentrated nature of the audit industry may not give rise to a significant increase in competition, the improved matching between specialized auditors and their clients should have a positive effect on audit quality.

The proposed amendments could also have a positive impact on the cost of audit firms' financing. The proposed amendments may result in an expanded set of choices among existing sources of financing. This could lead to more efficient financing activities for audit firms, thus potentially lowering the cost of capital for audit firms.[90] If financing costs for audit firms decrease as a result of the proposed amendments, then such savings may be passed on to the audit client in the form of lower audit fees. Investors also may benefit from reduced audit fees if the savings are passed on to investors. The Commission understands, however, that audit firms likely already receive favorable financing terms. Therefore, this effect may not be significant in practice.

The replacement of the bright-line 10 percent test with the significant influence test also potentially allows more financing channels for the covered persons in accounting firms and their immediate family members.[91] For example, the covered persons may not be able to borrow money from certain lenders due to potential non-compliance with the existing Loan Provision. A larger set of financing channels may potentially lead to lower cost of capital for covered persons, increasing their opportunities for investment.

2. Anticipated Costs and Potential Unintended Consequences

The proposed significant influence test may increase the demands on the time of auditors and audit clients to familiarize themselves with the test and gather and assess the relevant information to apply the test. However, given that the significant influence test has been part of the Commission's auditor independence rules since 2000 and has existed in U.S. GAAP since 1971, we do not expect a significant learning curve in applying the test. We also do not expect significant compliance costs for auditors to implement the significant influence test

[87] The proposed amendments could result in some crowding-out effect, as the four largest audit firms may be deemed to be independent with more clients under the proposed amendments, crowding out small audit firms. We discuss this effect in more detail in Section V.D below. However, we believe that better matching between auditor specialization and their clients and the reduced unnecessary auditor turnovers could potentially prevent audit quality decline and in the long run may improve audit quality.

[88] The concept of significant influence, as described in ASC Topic 323, Investments—Equity Method and Joint Ventures, incorporates a rebuttable presumption of significant influence once beneficial ownership exceeds 20% of an audit client's securities. We discuss the effects of this provision in Section II.C above.

[89] *See supra* footnote 64.

[90] Studies on capital markets across countries suggest that better access to financing leads to more investment efficiency. *See e.g.,* T. Rice & P. Strahan, *Does Credit Competition Affect Small-Firm Finance,* 65 J. Fin. 861–889 (2010); R. Mclean, T. Zhang & M. Zhao, *Why does the Law Matter? Investor Protection and its Effects on Investment, Finance, and Growth,* 67 J. Fin. 313–350 (2012); and J. Wurgler, *Financial Markets and the Allocation of Capital,* 58 J. Fin. 187–214 (2000).

[91] *See supra* footnote 11.

in the context of the Loan Provision given that they already are required to apply the concept in other parts of the auditor independence rules. We recognize that funds do not generally apply a significant influence test for financial reporting purposes. As such, despite the fact that they are required to apply the significant influence test to comply with the existing Commission independence rules, their overall familiarity in other contexts may be less. As a result, the proposed significant influence test may increase the demands on the time of funds and their auditors to gather and assess the relevant information and attendant costs.

The replacement of the bright-line threshold test with the significant influence test and the ''known through reasonable inquiry'' standard would introduce more judgment in the determination of compliance with the Loan Provision. As discussed earlier, the significant influence test contains multiple qualitative elements to be considered in determining whether an investor has significant influence over the operating and financial policies of the investee. These elements include, but are not limited to, representation on the board of directors; participation in policy-making processes; material intra-entity transactions; interchange of managerial personnel; and technological dependency. To the extent an auditor and audit client need to adjust their compliance activities to now focus on these new elements, there may be additional transition costs. The judgment involved in application of the significant influence test also could lead to potential risks regarding auditor independence. In particular, because the significant influence test relies on qualitative factors that necessarily involve judgment, there is a risk that the significant influence test could result in mistakenly classifying a non-independent auditor as independent under the Loan Provision. However, auditor reputational concerns may impose some discipline on the application of the significant influence test in determining compliance with the Loan Provision, thus mitigating this risk.

*D. Effects on Efficiency, Competition and Capital Formation*

The Commission believes that the proposed amendments are likely to improve the practicality of the Loan Provision, enhance efficiency of implementation, and reduce compliance burdens. They also may facilitate capital formation.

The proposed amendments may expand a particular audit client's choices by expanding the number of auditors that meet the auditor independence rules under the Loan Provision. As discussed earlier, the current bright-line test may be over-inclusive under certain circumstances. If more audit firms are eligible to undertake audit engagements without implicating the Loan Provision, then audit clients will have more options and as a result audit costs may decrease, although given the highly concentrated nature of the audit industry, this effect may not be significant. Moreover, the potential expansion of choice among eligible audit firms and the reduced threat of being required to switch auditors may lead to better matching between the audit client and the auditor. Improved matching between auditor specialties and audit clients could enable auditors to perform auditing services more efficiently, thus potentially reducing audit fees and increasing audit quality over the long term. Higher audit quality is linked to better financial reporting, which could result in a lower cost of capital. Reduced expenses and higher audit quality may decrease the overall cost of investing as well as the cost of capital, with potential positive effects on capital formation. However, due to the concentrated nature of the audit industry, we acknowledge that any such effects may not be significant.

The replacement of the existing bright-line test with the significant influence test could more effectively capture those relationships that may pose a threat to an auditor's objectivity and impartiality. To the extent that the proposed amendments do so, the quality of financial reporting is likely to improve, and the amount of board attention to independence questions when impartiality is not at issue is likely to be reduced, thus allowing a fund board to focus on its role as an independent check on fund management. An operating company's board might focus on hiring the best management, choosing the most value-enhancing investment projects, and monitoring management to maximize shareholder value. This sharpened focus could potentially benefit shareholders. Furthermore, we expect that improved identification of threats to auditor independence would increase investor confidence about the quality and accuracy of the information reported. Reduced uncertainty about the quality and accuracy of financial reporting should attract capital, and thus facilitate capital formation.

Under the proposed amendments, audit firms would potentially be able to draw upon a larger set of lenders. This potentially could lead to greater competition among the lending institutions, leading to lower borrowing costs for audit firms. Again, this could result in lower audit fees, lower fund fees, lower compliance expenses, and help facilitate capital formation, to the extent that lower borrowing costs for audit firms get passed on to their audit clients.

The proposed amendments also may potentially lead to changes in the competitive structure of the audit industry. We expect more accounting firms to be eligible to provide auditing services and be in compliance with auditor independence under the proposed amendments. If the larger audit firms are the ones more likely to engage in significant financing transactions and are more likely to not be in compliance with the existing Loan Provision, then these firms are more likely to be positively affected by the proposed amendments. In particular, these firms may be able to compete for or retain a larger pool of audit clients. At the same time, the larger firms' potentially increased ability to compete for audit clients could potentially crowd out the auditing business of smaller audit firms. However, we estimate that four audit firms already perform 88 percent of audits in the registered investment company space.[92] As a result, we do not expect any potential change in the competitive dynamics among auditors for registered investment companies to be significant.

*E. Alternatives*

The existing Loan Provision covers loans to and from the auditor by ''record or beneficial owners of more than 10 percent of the audit client's equity securities.'' As discussed earlier, record owners are relatively less likely to have incentives to take actions that would threaten auditor independence than are beneficial owners. An alternative approach to the proposed amendments would be to maintain the 10 percent bright-line test, but to distinguish between types of ownership under the 10 percent bright-line test and tailor the rule accordingly. For example, record owners could be excluded from the 10 percent bright-line test, to which beneficial owners would remain subject. The potential benefit of distinguishing

[92] The market share of the four largest accounting firms in other industries is significantly high as well. According to the sample of 7,180 registrants covered by Audit Analytics in 2016, the four largest accounting firms' mean (median) market share across industries (based on two digit standard industry code) is 58% (57%). The upper quartile is as high as 78% with low quartile of the distribution being 45%.

between types of ownership while retaining the 10 percent bright-line test is that applying a bright-line test would involve less judgment than the proposed significant influence test. Excluding record holders that may not have strong enough economic incentives or power to impair auditor independence could partially overcome the over-inclusiveness of the exiting rule. However, it still would not overcome the issues of over- or under-inconclusiveness with respect to beneficial owners.

A second alternative would be to use the materiality of a stock holding to the lender in conjunction with the significant influence test as a proxy for incentives that could threaten auditor independence. Specifically, the significance of the holding to the lender could be assessed based on the magnitude of the stock holding to the lender (*i.e.,* what percentage of the lender's assets are invested in the audit client's equity securities), after determining whether the lender has significant influence over the audit client. For example, two institutions that hold 15 percent of a fund may be committing materially different amounts of their capital to the specific investment. The incentives to influence the auditor's report are likely to be stronger for the lender that commits the relatively larger amount of capital to a specific investment. As such, the materiality of the investment to a lender with significant influence could be used as an indicator of incentives by the lender to attempt to influence the auditor's report. Materiality of a holding may better capture the incentives that could pose a threat to auditor independence. The potential cost to the auditors and audit clients could be that they need additional information and an additional layer of judgment in assessing their compliance with the Loan Provision. Also, given the size of most lenders, a materiality component might effectively exclude most, if not all, lending relationships that pose a threat to an auditor's objectivity and impartiality.

A third potential approach would be to assess the materiality of the lending relationship between the auditor and the lending institution. The materiality of the lending relationship between the lender and the auditor, from both the lender's and the auditor's point of views, could act as an indicator of the leverage that the lender may have if it attempts to influence the auditor's report. However, again, given the size of most impacted audit firms and lenders, a materiality component might effectively exclude most, if not all, lending relationships that pose a threat to an auditor's objectivity and impartiality.

### *F. Request for Comment*

We request and encourage any interested person to submit comments regarding the proposed amendments and all aspects of our analysis of the potential effects of the amendments. Comments are particularly helpful to us if accompanied by quantified estimates or other detailed analysis and supporting data regarding the issues addressed in those comments. We also are interested in comments on the alternatives presented in this release as well as any additional alternatives to the proposed amendments that should be considered. To assist in our consideration of these costs and benefits, we specifically request comment on the following:

- The costs and benefits of the proposed amendment to eliminate the requirement that audit firms analyze record holders under the Loan Provision.
- The costs and benefits of the proposed significant influence test.
- The costs and benefits of the proposed addition of a ''known through reasonable inquiry'' standard in applying the significant influence test.
- The costs and benefits of the proposed exclusion of the funds (other than the fund under audit) from being considered an affiliate of the audit client.
- The effect of the proposed amendments on the competitive structure of the audit industry.
- The effect of the proposed amendments on the quality of financial reporting.
- The effect of the proposed amendments on audit quality.
- The effect of the proposed amendments on capital formation.
- The effect of the proposed amendments on audit firms and their covered persons' financing.

## VI. Initial Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (''RFA'')[93] requires the Commission, in promulgating rules under section 553 of the Administrative Procedure Act,[94] to consider the impact of those rules on small entities. We have prepared this Initial Regulatory Flexibility Act Analysis (''IRFA'') in accordance with 5 U.S.C. 603. This IRFA relates to the proposed amendments to Rule 2–01 of Regulation S–X.

### *A. Reasons for and Objectives of the Proposed Action*

As discussed above, the primary reason for, and objective of, the proposed amendments is to address certain significant compliance challenges for audit firms and their clients resulting from application of the Loan Provision that do not otherwise appear to affect the impartiality or objectivity of the auditor. Specifically, the proposed amendments would:

- Focus the analysis solely on beneficial ownership;
- replace the existing 10 percent bright-line shareholder ownership test with a ''significant influence'' test;
- add a ''known through reasonable inquiry'' standard with respect to identifying beneficial owners of the audit client's equity securities; and
- amend the definition of ''audit client'' for a fund under audit to exclude from the provision funds that otherwise would be considered affiliates of the audit client.

The reasons for, and objectives of, the proposed rules are discussed in more detail in Sections I and II above.

### *B. Legal Basis*

We are proposing the amendments pursuant to Schedule A and Sections 7, 8, 10, and 19 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, and 23 of the Exchange Act, Sections 8, 30, 31, and 38 of the Investment Company Act, and Sections 203 and 211 of the Investment Advisers Act.

### *C. Small Entities Subject to the Proposed Rules*

The proposed amendments would affect small entities that file registration statements under the Securities Act, the Exchange Act, and the Investment Company Act and periodic reports, proxy and information statements, or other reports under the Exchange Act or the Investment Company Act, as well as smaller registered investment advisers and smaller accounting firms. The RFA defines ''small entity'' to mean ''small business,'' ''small organization,'' or ''small governmental jurisdiction.''[95] The Commission's rules define ''small business'' and ''small organization'' for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Securities Act Rule 157[96] and Exchange Act Rule 0–10(a)[97] defines an issuer, other than

[93] 5 U.S.C. 601 *et seq.*

[94] 5 U.S.C. 553.

[95] 5 U.S.C. 601(6).

[96] 17 CFR 230.157.

[97] 17 CFR 240.0–10(a).

an investment company, to be a ''small business'' or ''small organization'' if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 1,163 issuers, other than registered investment companies, that may be subject to the proposed amendments.[98] The proposed amendments would affect small entities that have a class of securities that are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. In addition, the proposed amendments would affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn.

An investment company is considered to be a ''small business'' for purposes of the RFA, if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less at the end of the most recent fiscal year.[99] We believe that the proposed amendments would affect small entities that are investment companies. Commission staff estimates that, as of December 31, 2017, there were 54 open-end investment companies (within 52 fund complexes) that would be considered small entities. This number includes open-end ETFs.[100]

For purposes of the RFA, an investment adviser is a small entity if it:

(1) Has assets under management having a total value of less than $25 million;

(2) did not have total assets of $5 million or more on the last day of the most recent fiscal year; and

(3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[101] We estimate that there are approximately 557 investment advisers that would be subject to the proposed amendments that may be considered small entities.[102]

For purposes of the RFA, a broker-dealer is considered to be a ''small business'' if its total capital (net worth plus subordinated liabilities) is less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act,[103] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and that is not affiliated with any person (other than a natural person) that is not a small business or small organization.[104] As of the year end of 2017, there are approximately 1,042 small entity broker-dealers that may be subject to the proposed amendments.[105]

Our rules do not define ''small business'' or ''small organization'' for purposes of accounting firms. The Small Business Administration (SBA) defines ''small business,'' for purposes of accounting firms, as those with under $20.5 million in annual revenues.[106] We have limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than $20.5 million in annual revenue. We request comment on the number of accounting firms with revenue under $20.5 million.

*D. Projected Reporting, Recordkeeping and Other Compliance Requirements*

The proposed amendments would not impose any reporting, recordkeeping, or disclosure requirements. The proposed amendments would impose new compliance requirements with respect to the Loan Provision.

Although we are proposing to replace the 10 percent bright-line test with a ''significant influence'' test that requires the application of more judgment, we believe that the proposed amendments would not significantly increase costs for smaller entities, including smaller accounting firms. The concept of ''significant influence'' already exists in the auditor independence rules and in U.S. GAAP,[107] and accounting firms, issuers and their audit committees are already required to apply the concept in these contexts and may have developed practices, processes or controls for complying with these provisions.[108] We believe that these entities likely would be able to leverage any existing practices, processes or controls to comply with the proposed amendments.

We also believe that the proposed ''known through reasonable inquiry'' standard would not significantly increase costs for smaller entities, including smaller accounting firms. The ''known through reasonable inquiry'' standard is generally consistent with regulations implementing the Investment Company Act, the Securities Act and the Exchange Act.[109] Smaller entities, including smaller accounting firms, should therefore already be familiar with the concept.

In addition, we believe that the proposed amendments to exclude record owners and certain fund affiliates for purposes of the Loan Provision would reduce costs for smaller entities, including smaller accounting firms.

Compliance with the proposed amendments would require the use of professional skills, including accounting and legal skills. The proposed amendments are discussed in detail in Section II above. We discuss the economic impact, including the estimated costs, of the proposed amendments in Section V (Economic Analysis) above.

*E. Duplicative, Overlapping, or Conflicting Federal Rules*

We believe that the proposed amendment would not duplicate, overlap or conflict with other federal rules.

*F. Significant Alternatives*

The RFA directs us to consider alternatives that would accomplish our stated objectives while minimizing any significant adverse impacts on small entities. In connection with the proposed amendments, we considered certain types of alternatives, including:

(1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities;

(2) The clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities;

(3) The use of performance rather than design standards; and

[98] This estimate is based on staff analysis of XBRL data submitted with EDGAR filings of Forms 10–K, 20–F and 40–F and amendments filed during the calendar year of January 1, 2017 to December 31, 2017.

[99] 17 CFR 270.0–10(a).

[100] This estimate is derived from an analysis of data obtained from Morningstar Direct as well as data reported on Form N–SAR filed with the Commission for the period ending June 30, 2017.

[101] 17 CFR 275.0–7.

[102] This estimate is based on Commission-registered investment adviser responses to Form ADV, Part 1A, Items 5.F and 12.

[103] 17 CFR 240.17a–5(d).

[104] 17 CFR 240.0–10(c).

[105] This estimate is based on the most recent information available, as provided in Form X–17A–5 Financial and Operational Combined Uniform Single Reports filed pursuant to Section 17 of the Exchange Act and Rule 17a–5 thereunder.

[106] 13 CFR 121.201 and North American Industry Classification System (NAICS) code 541211. The SBA calculates ''annual receipts'' as all revenue. *See* 13 CFR 121.104.

[107] *See supra* footnote 48; *see also* ASC 323, *supra* footnote 49.

[108] Although the concept of ''significant influence'' is not as routinely applied today in the funds context for financial reporting purposes, nevertheless, the concept of significant influence is applicable to funds under existing auditor independence rules. *See supra* Section II.C.

[109] *See supra* footnote 64.

(4) An exemption from coverage of the rule, or any part of the rule, for small entities.

In connection with our proposed amendments to Rule 2–01 of Regulation S–X, we do not think it feasible or appropriate to establish different compliance or reporting requirements or timetables for small entities. The proposed amendments are designed to address compliance challenges for both large and small issuers and audit firms. With respect to clarification, consolidation or simplification of compliance and reporting requirements for small entities, the proposed amendments do not contain any new reporting requirements. While the proposed amendments would create a new compliance requirement that focuses on ''significant influence'' over the audit client to better identify those lending relationships that could impair an auditor's objectivity and impartiality, that standard is more qualitative in nature and its application would vary according to the circumstances. This more flexible standard would be applicable to all issuers, regardless of size.

With respect to using performance rather than design standards, we note that our proposed amendments establishing a ''significant influence'' test and adding a ''known through reasonable inquiry'' standard are more akin to performance standards. Rather than prescribe the specific steps necessary to apply such standards, the proposed amendments recognize that ''significant influence'' and ''known through reasonable inquiry'' can be implemented in a variety of ways. We believe that the use of these standards would accommodate entities of various sizes while potentially avoiding overly burdensome methods that may be ill-suited or unnecessary, given the facts and circumstances.

The proposed amendments are intended to address significant compliance challenges for audit firms and their clients, including those that are small entities. In this respect, exempting small entities from the proposed amendments would increase, rather than decrease, their regulatory burden relative to larger entities.

### *G. Solicitation of Comment*

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- The number of small entities that may be subject to the proposed amendments;
- The existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis;
- How to quantify the impact of the proposed amendments; and
- Alternatives that would accomplish our stated objectives while minimizing any significant adverse impact on small entities.

Respondents are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments.

## VII. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA''),[110] the Commission must advise the Office of Management and Budget as to whether a proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' when, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review.

We request comment on whether our proposed amendments would be a ''major rule'' for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment or innovation.

We request those submitting comments to provide empirical data and other factual support for their views to the extent possible.

## VIII. Statutory Basis

The amendment described in this release is being adopted under the authority set forth in Schedule A and Sections 7, 8, 10, and 19 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, and 23 of the Exchange Act, Sections 8, 30, 31, and 38 of the Investment Company Act, and Sections 203 and 211 of the Investment Advisers Act.

[110] Public Law 104–121, Tit. II, 110 Stat. 857 (1996).

### List of Subjects in 17 CFR Parts 210

Accountants, Accounting, Banks, Banking, Employee benefit plans, Holding companies, Insurance companies, Investment companies, Oil and gas exploration, Reporting and recordkeeping requirements, Securities, Utilities.

In accordance with the foregoing, the Commission proposes to amend title 17, chapter II of the Code of Federal Regulations as follows:

## PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

■ 1. The authority citation for part 210 continues to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78c, 78j–1, 78*l*, 78m, 78n, 78o(d), 78q, 78u–5, 78w, 78*ll*, 78mm, 80a–8, 80a–20, 80a–29, 80a–30, 80a–31, 80a–37(a), 80b–3, 80b–11, 7202 and 7262, and sec. 102(c), Public Law 112–106, 126 Stat. 310 (2012), unless otherwise noted.

■ 2. Amend § 210.2–01 by revising paragraph (c)(1)(ii)(A) to read as follows:

### § 210.2–01 Qualifications of accountants.

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(A) *Loans/debtor-creditor relationship.* (*1*) Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(*i*) Automobile loans and leases collateralized by the automobile;

(*ii*) Loans fully collateralized by the cash surrender value of an insurance policy;

(*iii*) Loans fully collateralized by cash deposits at the same financial institution; and

(*iv*) A mortgage loan collateralized by the borrower's primary residence

provided the loan was not obtained while the covered person in the firm was a covered person.

(*2*) For purposes of paragraph (c)(1)(ii)(A) of this section:

(*i*) The term *audit client* for a fund under audit excludes any other fund that otherwise would be considered an *affiliate of the audit client;*

(*ii*) The term *fund* means 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 of 1940 (15 U.S.C. 80a–3(c)).

* * * * *

By the Commission.

Dated: May 2, 2018.

**Brent J. Fields,**

*Secretary.*

[FR Doc. 2018–09721 Filed 5–7–18; 8:45 am]

**BILLING CODE 8011–01–P**

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## DEPARTMENT OF THE INTERIOR

### Office of Surface Mining Reclamation and Enforcement

### 30 CFR Part 926

**[SATS No. MT–036–FOR; Docket ID: OSM–2017–0001; S1D1S SS08011000 SX064A000 189S180110; S2D2S SS08011000 SX064A000 18XS501520]**

### Montana Regulatory Program

**AGENCY:** Office of Surface Mining Reclamation and Enforcement, Interior.

**ACTION:** Proposed rule; public comment period and opportunity for public hearing on proposed amendment.

**SUMMARY:** We, the Office of Surface Mining Reclamation and Enforcement (OSMRE), are announcing receipt of a proposed amendment to the Montana regulatory program (Montana program) under the Surface Mining Control and Reclamation Act of 1977 (SMCRA or the Act). Montana proposes an addition to the Montana Code Annotated, which requires the adoption of regulations pertaining to in situ coal gasification. This change was necessitated by a senate bill approved by the 2011 Montana Legislature. Montana also proposes revisions and additions to the Administrative Rules of Montana to satisfy the new statutory requirement.

This document provides the times and locations that the Montana program and this proposed amendment to Montana's program are available for your inspection; the comment period during which you may submit written comments on the amendment; and the procedures that we will follow for the public hearing, if one is requested.

**DATES:** We will accept written comments on this amendment until 4:00 p.m., m.d.t., June 7, 2018. If requested, we will hold a public hearing on the amendment on June 4, 2018. We will accept requests to speak at a hearing until 4:00 p.m., m.d.t. on May 23, 2018.

**ADDRESSES:** You may submit comments, identified by Docket Number OSM–2017–0001, by any of the following methods:

- *Mail/Hand Delivery:* 1999 Broadway, Suite 3320, Denver, CO 80202.
- *Fax:* (303) 293–5017.
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

*Instructions:* All submissions received must include the agency name and docket number for this rulemaking. For detailed instructions on submitting comments and additional information on the rulemaking process, see the ''Public Comment Procedures'' heading of the **SUPPLEMENTARY INFORMATION** section of this document.

*Docket:* For access to the docket to review copies of the Montana program, this amendment, a listing of any scheduled public hearings, and all written comments received in response to this document, you may go to the address listed below during normal business hours, Monday through Friday, excluding holidays. The full text of the program amendment is also available for you to read at *www.regulations.gov.* You may receive one free copy of the amendment by contacting OSMRE's Denver Field Division: Jeffrey Fleischman, Chief, Denver Field Division, Office of Surface Mining Reclamation and Enforcement, Dick Cheney Federal Building, POB 11018, 150 East B Street, Casper, Wyoming 82601–7032, Telephone: (307) 261–6550, Email: *jfleischman@osmre.gov.*

In addition, you may receive a copy of the proposed amendment from the Montana Department of Environmental Quality: Edward L. Coleman, Chief, Coal and Opencut Mining Bureau, Montana Department of Environmental Quality, P.O. Box 200901, Helena, Montana, 59620–0901, Telephone: (406) 444–4973, Email: *ecoleman@mt.gov.*

**FOR FURTHER INFORMATION CONTACT:** Howard Strand, Office of Surface Mining Reclamation and Enforcement, 1999 Broadway, Suite 3320, Denver, CO 80202, Telephone: (303) 293–5026, Email: *hstrand@osmre.gov.*

**SUPPLEMENTARY INFORMATION:**

I. Background on the Montana Program
II. Description of the Proposed Amendment
III. Public Comment Procedures
IV. Procedural Determinations

### I. Background on the Montana Program

Section 503(a) of the Act permits a state to assume primacy for the regulation of surface coal mining and reclamation operations on non-federal and non-Indian lands within its borders by demonstrating that its program includes, among other things, state laws and regulations that govern surface coal mining and reclamation operations in accordance with the Act and consistent with the Federal regulations. See 30 U.S.C. 1253(a)(1) and (7). On the basis of these criteria, the Secretary of the Interior conditionally approved the Montana program on April 1, 1980. You can find background information on the Montana program, including the Secretary's findings, the disposition of comments, and conditions of approval of the Montana program in the April 1, 1980, **Federal Register** (45 FR 21560). You can also find later actions concerning the Montana program and program amendments at 30 CFR 926.15, 926.16, and 926.30.

### II. Description of the Proposed Amendment

By letter dated February 27, 2017 (FDMS Document ID No. OSM–2017–0001–0002), Montana sent us a proposed amendment to its program under SMCRA (30 U.S.C. 1201 *et seq.*). The proposed changes are the result of a Montana state senate bill which required adoption of regulations pertaining to in situ coal gasification.

Specifically, Montana proposes to codify language from Senate Bill 292 under the Montana Strip and Underground Mine Reclamation Act. This language, approved by the 2011 Montana Legislature, directs the Montana Board of Environmental Review (BER) to adopt rules pertaining to in situ coal processing and provides that those rules may not be more stringent than the comparable federal regulations or guidelines. The Administrative Rules of Montana (ARMs) currently have two regulatory provisions, ARM 17.24.902 and ARM 17.24.904, that specifically address in situ coal gasification and that list subchapters of the ARMs that apply to in situ coal gasification. Following passage of Senate Bill 292, the Montana Department of Environmental Quality reviewed Montana's rules and determined that most of the rules relating to underground coal mining should apply to in situ operations. It recommended that, rather than adopting rules that would duplicate existing rules, BER should simply list the rules that would not apply to in situ operations. To reflect this approach,