



# MUTUAL FUND DIRECTORS FORUM

*The FORUM for FUND INDEPENDENT DIRECTORS*

July 9, 2018

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

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

Dear Mr. Fields:

The Mutual Fund Directors Forum (“the Forum”)<sup>1</sup> welcomes the opportunity to comment on the Commission’s recent proposal regarding the application of auditor independence rules to situations where an audit firm has a loan relationship with certain shareholders of an investment company.<sup>2</sup>

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

Forum members sit on audit committees of investment companies and are therefore responsible for selecting and overseeing fund independent auditors. While auditors must communicate to audit committees any relationships that might implicate independence,<sup>3</sup> the directors must be comfortable that the auditors are independent from the funds that they audit. As a result of the loan provision, audit committees of investment companies are now receiving information on issues that may technically implicate auditor independence under the loan provision, but that do not have any bearing on the actual independence of the auditors. The

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<sup>1</sup> The Forum’s current membership includes over 945 independent directors, representing 127 mutual fund groups. Each member group selects a representative to serve on the Forum’s Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum’s Board of Directors, although it does not necessarily represent the views of all members in every respect.

<sup>2</sup> Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Release No. 33-10491; 34-83157; IC-33091; IA-4904, 83 FR 20753 (May 8, 2018) (“Proposing Release”).

<sup>3</sup> See, PCAOB Rule 3526.

application of the “loan provision”<sup>4</sup> in the mutual fund context has therefore presented particular challenges for fund boards.

We applaud the Commission for providing a common-sense interpretation of the loan provision that will allow audit committees to more effectively ascertain whether their auditors have a genuine conflict of interest. Both fund directors and their shareholders would benefit greatly from this change. Fund boards would be relieved of the responsibility of combing through volumes of irrelevant information regarding relationships that do not compromise independence, and shareholders would no longer bear the burden of the expenses associated with generating unhelpful information.

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The loan provision is part of the Commission’s auditor independence rules contained in Regulation S-X.<sup>5</sup> It provides that an accountant is not independent when the accounting firm, or certain members of the firm or their immediate family members, have a loan to or from an audit client, the audit client’s officers or directors, or any “record or beneficial owners of more than 10 percent of the audit client’s equity securities.”<sup>6</sup>

Rigid adherence to the loan provision in the investment company context results in a wide range of fact patterns that do not impair the auditors’ objectivity and impartiality. However, accounting firms must provide the fund audit committee with information about these facts, which the committees then spend time evaluating. If there were in fact a relationship that could cast doubt upon the auditors’ independence or objectivity, the large volume of irrelevant data now being provided to fund audit committees as a result of the loan provision could potentially obscure a significant issue. This result is not in the best interests of fund shareholders.

The Commission’s proposed amendments would make the rule much more workable in the mutual fund space and thus largely eliminate reporting of relationships that do not impair independence. The amendments would:

- Focus on beneficial ownership;
- Replace the ten percent “bright line” test with a “significant influence” test;
- Add a “known through reasonable inquiry” standard for identifying beneficial owners of client securities; and
- Amend the definition of “audit client” for funds to exclude funds that would be considered “affiliates of the audit client.”

The focus on “beneficial” ownership eliminates the issue of intermediaries holding shares in omnibus accounts on behalf of shareholders triggering the provision. The application of the current loan provision to both “record” and “beneficial” owners of a fund’s shares is over-inclusive

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<sup>4</sup> Rule 2-01(c)(1)(ii)(A).

<sup>5</sup> Rule 2-01(c)(1)(ii)(A) of Regulation S-X

<sup>6</sup> *Id.*

in the fund space as the rule implicates financial intermediaries that hold shares in omnibus accounts on behalf of many individual shareholders. These financial intermediaries may be lenders to an accounting firm or affiliated with financial institutions that lend to the accounting firm. However, while the financial intermediaries may “own,” on a record basis, more than ten percent of a given fund’s shares, these entities have no ability to influence or exercise voting control for the record shares. The focus on beneficial ownership combined with the “significant influence” test grants auditors and audit committees more flexibility to apply their professional judgment about situations that actually create the possibility (or potential) of significant influence over the audit client.

The “known through reasonable inquiry” provision is also helpful in the context of a securities market where shareholders are not static and where large omnibus accounts can move in or out of particular funds without the knowledge of the audit firm. In situations where the auditor is unaware, after reasonable inquiry, that (for example) an affiliate of one of its lenders owns shares in an audit client, it is highly unlikely that the auditors’ independence or objectivity could be impaired.

The amended definition of “audit client” is also sensible in its approach to defining what constitutes a fund affiliate. Currently the loan provision implicates other funds within the fund complex, as well as affiliated entities, even if the auditor does not audit those entities. Amending the definition of “audit client” eliminates that potentially problematic conclusion.

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For the reasons outlined above, we support the Commission’s revised approach to auditor independence with respect to the loan provision. We would welcome the opportunity to further discuss our views with you. Please feel free to contact Susan Ferris Wyderko, the Forum’s President, or Carolyn McPhillips, the Forum’s Senior Counsel, if you should like to do so.

Sincerely,

A handwritten signature in cursive script that reads "Susan Ferris Wyderko". The signature is written in black ink and is positioned above the printed name and title.

Susan Ferris Wyderko  
President/CEO