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Submitted electronically through http://www.regulations.gov

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

Re: **Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships: File Number S7-10-18**

Dear Mr. Fields,

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its proposed amendments to Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Provision"), which prohibits certain debtor-creditor relationships between significant shareholders in publicly-offered entities and the independent auditors of those entities.

Fidelity strongly supports the SEC's proposed changes to the Loan Provision. We agree with the SEC that the current Loan Provision applies in certain circumstances in which the objectivity and impartiality of the auditor is not impaired.[2] We also agree that the current Loan Provision creates significant practical and operational challenges.[3] In the context of registered investment companies and other pooled investment vehicles (individually, "Fund" and collectively, "Funds"), we believe that the proposed amendments appropriately narrow the application of the Loan Provision and, if adopted, should reduce the operational burdens associated with the rule.

We also appreciate the SEC Staff's willingness to discuss and address the concerns raised by the investment management industry on the application of the Loan Provision over the last two years.[4] We believe that this dialog has resulted in a rule proposal that, if adopted, will create

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[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.
[2] Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships; Release No. 33-10491, 34-83157, IC-33091; IA-4904 (May 2, 2018) [83 Fed. Reg. 20753 (May 8, 2018)] (the "Release") at 20756.
[3] *Id.*
[4] Fidelity sought and received No-Action Relief from the Staff of the Division of Investment Management on the application of the Loan Provision in certain circumstances in 2016. *See* No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (June 20, 2016), available at https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm (the "2016 Fidelity No-Action Letter"); No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (Sept. 22, 2017), available at

a more effective and workable Loan Provision, while still meeting the SEC's goal of ensuring that auditors are "independent of their audit clients both 'in fact and in appearance.'"[5] In this letter, we suggest certain modifications to the proposal that will enhance the effectiveness of the Loan Provision even further and we address several of the questions posed by the Commission in the Release.

I. INTRODUCTION AND EXECUTIVE SUMMARY

The SEC's amendments to the Loan Provision would: (i) remove record ownership from the Loan Provision and instead focus the rule solely on instances of beneficial ownership, (ii) add a standard for identifying beneficial owners, (iii) amend the definition of "audit client" in the Fund context to exclude affiliated funds, and (iv) replace the current 10% shareholder ownership test with a "significant influence" test. In the remainder of this letter, we discuss the following:

- We agree with the SEC's description of the substantive and practical concerns with the existing Loan Provision.

- We support replacing the 10% ownership test with the significant influence test. This change will only be effective for Funds, however, when accompanied by the additional guidance on the interpretation of significant influence in the Fund context provided by the SEC in the Release.[6] We strongly support this guidance and encourage the SEC to repeat the guidance in the adopting release accompanying the final amendments to the Loan Provision.

- In addition to excluding affiliated funds from the definition of "audit client," we encourage the SEC to also exclude other entities that are included in a fund's investment company complex.

II. CONCERNS WITH EXISTING LOAN PROVISION

A. Current Loan Provision is Over-Inclusive

We agree with the Commission that auditors can be found to have violated the rule in cases where there is no threat to the auditor's independence.[7] For example, shares of mutual

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https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm (the "2017 Fidelity No-Action Letter" and together with the 2016 Fidelity No-Action Letter, collectively, the "Fidelity No-Action Letter").

[5] Release at 20754, citing Preliminary Note 1 to Rule 2-01 of Regulation S-X.

[6] *Id.* at 20761.

[7] *Id.* at 20758. As the SEC noted in the Release, the consequences of a determination that an auditor is not independent are draconian in the Fund context. If an auditor is found not to be independent, the Fund must either engage a different independent auditor to re-audit the Fund's financial statements or the Fund must discontinue offering shares for purchase. These consequences are disruptive and costly to Funds and their shareholders, and should be reserved only for instances in which an auditor is truly not independent.

funds are often held by institutions for the benefit of many underlying shareholders on a record basis. The institution will aggregate purchase and redemption activity for a particular fund in all of the underlying customer accounts on a daily basis and then place one net purchase or net redemption with the Fund. The aggregated holdings of these underlying customers can be substantial. In these cases, while the institution may be considered a “shareholder” on the books of the Fund, the institution is not a true shareholder. It has no vested interest in the Fund’s performance and does not possess the rights afforded shareholders. As a result, there is no policy reason for the Loan Rule to apply in these circumstances and we support the SEC’s proposal to remove record ownership from the rule.

As a general matter, shareholders in Funds that calculate and publish net asset values on a daily basis have little to gain by attempting to influence an auditor’s work in reviewing the Fund’s financial statements. Influencing the audit processes, which, in the case of mutual funds, occur in the two months after a Fund’s fiscal year end, will not provide any financial benefit to the shareholder. Funds that calculate and publish net asset values on a daily basis allow a shareholder to understand his or her investment return each day. Between the end of the Fund’s fiscal year and the time by which the Fund must provide its audited financial statements to the SEC and to shareholders, the Fund will have calculated and published its daily net asset value approximately 40 more times.

In addition, the 10% bright-line threshold in the existing Loan Provision does not work well in the Fund context. As the SEC states in the release, the 10% bright-line threshold was originally designed as a proxy for identifying shareholders who have a “special and influential role” with the issuer.[8] In the case of a public operating company, a test based on an ownership percentage may be appropriate. Holding a significant number of shares may be indicative of a shareholder maintaining influence over the operations of the company. This is not the case in the Fund context. Whether a shareholder in a Fund has a special and influential role with the Fund is not correlated with the *percentage* of the shareholder’s ownership but rather on the characteristics associated with that ownership. For example, a private Fund may give certain shareholders the ability to participate in the Fund’s investment decisions or in the Fund’s valuation processes while shareholders in another Fund may not be granted similar rights.[9] These factors are more indicative of a shareholder’s special role with the issuer than the percentage of ownership.

Furthermore, especially in the case of open-end mutual funds, the identity of the shareholders can change daily. Shareholders who hold more than 10% of the Fund’s voting securities today may hold less than 10% tomorrow through their own redemption activity or through purchases of Fund shares by others. Likewise, shareholders who hold less than 10% today may hold more than 10% tomorrow if other shareholders redeem. Under the current Loan Provision, however, lending relationships involving shareholders who hold just over 10% are

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[8] *Id.* at 20755.
[9] *Id.* at 20761.

thought to pose greater concern than lending relationships involving shareholders who hold just under 10%, even though there is no substantive difference between the two shareholders.

B. Identifying Prohibited Lending Relationships Imposes Unnecessary Costs and Burdens

The process of searching for and reporting circumstances that may violate the prohibitions in the Loan Provision have forced audit committees to waste valuable time and energy and have imposed unnecessary costs on fund shareholders.[10] Under the existing Loan Provision, a loan at *any time* involving a 10% shareholder constitutes a violation. Because the shareholders in a Fund change constantly, the current Loan Provision appears to require audit firms and, by extension, fund companies to review share ownership records and lending relationships constantly. Application of the rule in this manner is unworkable in practice and is not an effective use of shareholder resources.

Instead, over the last two years, audit firms have searched for possible violations of the Loan Provision involving Funds at various times during the year, including when the annual engagement letter is signed and upon issuance of an audit opinion. Notwithstanding the relief granted by the Staff in the Fidelity No-Action Letter, audit firms have felt compelled by the Public Company Accounting Oversight Board ("PCAOB") to search for possible "violations" even when the ultimate outcome of the inquiry (i.e., that no threat to independence exists) is foreordained. Once an audit firm uncovers lending relationships for which no threat to independence exists under the Fidelity No-Action Letter, audit firms are still required by PCAOB rules to report these matters to the funds' audit committees.[11] This has needlessly forced audit committees to spend time and energy understanding these technical violations, even though the conclusion of the audit firm is always that the firm maintains the requisite objectivity and impartiality to audit the funds' financial statements. We also concur with the SEC's sentiment that such communications, "…may dilute the impact of communications that identify issues that may actually raise concerns about an auditor's independence."[12]

III. SIGNIFICANT INFLUENCE

A. Fidelity Supports the Significant Influence Standard and the Guidance for Funds

Fidelity supports the proposed changes to the rule and we appreciate the degree to which the Commission and the Staff have considered the practical challenges faced by the investment management industry in crafting the proposed changes. In particular, we believe that the adoption of the significant influence test, when accompanied with the guidance on the application of the test in the Fund context, presents a workable and more effective alternative

[10] *Id.* at 20759.
[11] *Id.* at 20758.
[12] *Id.*

than the current rule.[13] We also believe that the proposal appropriately focuses attention 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."[14]

The Fund Guidance sets forth certain criteria that audit firms would examine when determining whether significant influence exists. For example, the SEC defines a Fund's "portfolio management processes" as the processes for day-to-day purchase and sale decisions, the valuation of a Fund's investments and the distribution of income and capital gains.[15] The Release then notes that audit firms could conclude that no significant influence exists in cases where the Fund's advisory contract gives the investment advisor, "…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."[16] Furthermore, a shareholder's ability to vote to approve the advisory contract or a Fund's fundamental policies on a *pro rata* basis with other shareholders does not imply that significant influence is present.[17]

We support the Fund Guidance because we believe that the SEC has identified the areas that a shareholder attempting to exert influence over a Fund would target. Shareholders seeking to influence the outcome of their investments in a Fund have little to gain by influencing the conduct of an audit and more to gain by influencing those processes that result in changes to the value of their investment in the Fund, including the portfolio investment decisions made by the Fund's advisor and the daily valuation processes. These areas are central to the financial results that a shareholder experiences by investing in the Fund. By directing attention to these portfolio management processes, the SEC has crafted a solution that meets its stated goal of more effectively identifying, "…shareholders 'having a special and influential role with the issuer.'"[18]

We also believe that the Fund Guidance will ease the operational and practical challenges associated with the current Loan Provision. Under the Fund Guidance, an audit firm would only need to evaluate whether lending relationships exist between a beneficial owner of 20% or more of a Fund's shares and the audit firm or its covered persons, if the audit firm first determines that significant influence *could* exist based on the Fund's portfolio management processes.[19] In those cases where a shareholder could not exert significant influence, the audit firms and fund complexes would not need to research and evaluate share ownership records and lending relationships. In most circumstances, the Fund Guidance will eliminate the need for the costly review processes that are currently being performed and will avoid the need to divert the attention of audit committees away from more substantive matters.

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[13] The guidance on the application of the significant influence test in the fund context can be found in the Release at 20761 and we refer to the guidance in this letter as the, "Fund Guidance."
[14] Release at 20760.
[15] *Id.* at 20761.
[16] *Id.*
[17] *Id.*
[18] *Id.* at 20760.
[19] *Id.* at 20761.

In fact, Fidelity would have serious concerns with the significant influence test if it were not accompanied by the Fund Guidance. For Funds, a significant influence test alone would represent at best a marginal improvement over the current 10% bright-line test. As noted in the Release, the SEC intends for the significant influence test to follow the principles in existing guidance from the Financial Accounting Standards Board ("FASB").[20] Accordingly, a lender that beneficially owns 20% or more of the audit client's voting securities would be presumed to have the ability to exercise significant influence over the audit client.[21] It would then be the responsibility of the audit firms and, by extension, the Funds to rebut the presumption based on, "…predominant evidence to the contrary."[22] Likewise, a lender that beneficially owns less than 20% would be presumed not to have significant influence.

In the absence of the Fund Guidance, this test would effectively replace one numeric threshold with another. Audit firms and fund companies would be required to monitor for instances of beneficial ownership exceeding the new threshold and, once discovered, would then analyze any mitigating factors in an effort to rebut the presumption of significant influence. In the Release, the SEC cites the mitigating factors listed in ASC 323, including, among others, opposition by the Fund in a formal proceeding challenging the shareholder's exercise of significant influence, the existence of an agreement under which the shareholder surrenders significant shareholder rights and the shareholder trying and failing to obtain representation on the Fund's board. As a factual matter, these mitigating factors simply do not apply in the Fund context and, thus, audit firms and fund companies will not be able to rebut the presumption. This does not imply, however, that the shareholder has the ability to exert significant influence over the Fund's operating and financial policies or that the shareholder maintains a special and influential role with the Fund.

In issuing the Fund Guidance, the SEC has effectively (and correctly) removed the percentage of share ownership from the test. As stated above, numeric thresholds, such as the current 10% bright-line test or the 20% rebuttable presumption, make little sense for Funds because the ability to influence a Fund is based on the fund's governance structure and the rights afforded shareholders rather than on the *amount* of share ownership. The advantage of the Fund Guidance is that it focuses on the substantive areas in which influence could be exerted rather than these numeric thresholds.

B. Fund Guidance should be Restated in Final Release

In light of the importance of the Fund Guidance, we encourage the SEC to repeat it in the adopting release accompanying the final amendments to the Loan Provision. We understand that guidance of this sort would not be included in the text of the amended rule itself. If the Fund Guidance is not included in the final release, industry participants may wonder whether the SEC had backed away from the guidance. Furthermore, if the SEC makes other changes to the Loan Provision in the final version, some may question how to interpret the Fund Guidance based on

[20] Release at 20760, citing FASB's ASC Topic 323, Investments – Equity Method and Joint Ventures ("ASC 323").
[21] Release at 20761.
[22] *Id.*

those changes. Reissuing the Fund Guidance in the final release will remove any such concerns and will allow industry participants to rely on the guidance in a manner free from doubt.

IV. DEFINITION OF AUDIT CLIENT

Currently, if a violation of the Loan Provision is found to exist with respect to one fund in a complex of funds, a violation exists with respect to all other funds in that same complex.[23] This does not work well in the Fund context because, as the SEC states in the Release, investors in one fund, "…typically do not possess the ability to influence the policies or management of another fund in the same fund complex."[24] In light of the consequences of determining that an auditor is not independent, such a rule inappropriately penalizes other Funds and their shareholders when no threat to independence exists. As a result, we support the SEC's proposal to remove affiliated funds from the definition of "audit client" so that a violation for one fund will not taint all other funds in the same complex.

Furthermore, we encourage the SEC to go one step further and remove other entities from the definition of "audit client." Regulation S-X defines an "affiliate of the audit client" to include, among others, "each entity in the investment company complex when the audit client is an entity that is part of an investment company complex."[25] The definition of "investment company complex" includes a number of entities in addition to the Fund under audit, including the Fund's investment advisor, the parent company or any subsidiaries of the investment advisor, and any entity under common control with the investment advisor if the entity is itself an investment advisor or provides administrative, custodian, underwriting or transfer agent services to investment companies, advisors or sponsors ("Affiliated Companies").[26]

Under the definitions of audit client and investment company complex, a violation of the Loan Provision involving a particular Fund would mean that the auditor is not independent of the Fund, as well as not independent of the Affiliated Companies. As a result, any of the Affiliated Companies would be unable to hire the firm to audit its financial statements. We believe that this is too narrow of an application of the SEC's independence rules. Whether the Affiliated Companies are not independent of their audit firms should be based on a more fulsome view into the relationships between Affiliated Companies and the audit firm, as well as the larger business in which the Affiliated Companies reside. The fact that a violation of the Loan Provision arises for one Fund serviced by the Affiliated Companies does not imply that the auditor does not maintain the requisite objectivity and impartiality to audit the Affiliated Companies' financial statements. For these reasons, we encourage the SEC to exclude any Affiliated Companies from the definition of audit client for purposes of the Loan Provision.

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[23] *Id.* at 20762.
[24] *Id.*
[25] Regulation S-X Rule 2-01(f)(4)(iv).
[26] Regulation S-X Rule 2-01(f)(14)(i).

Fidelity would be pleased to provide further information, participate in any direct outreach efforts the Commission undertakes, or respond to questions the Commission may have about our comments.

Sincerely,

cc: The Honorable Jay Clayton, Chair
The Honorable Robert J. Jackson Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Kara M. Stein, Commissioner

Dalia Blass, Director, Division of Investment Management

Fidelity INVESTMENTS