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

Re: *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships (File No. S7-10-18)*

Dear Mr. Fields:

Invesco Advisers, Inc. ("Invesco") is pleased to have the opportunity to comment on the Securities and Exchange Commission's (the "Commission") proposal to amend its rules on auditor independence with respect to certain loans and debtor-creditor relationships.[1] Invesco is a registered investment adviser that, along with its investment advisory affiliates, advises more than 300 registered investment companies, including mutual funds, exchange-traded funds ("ETFs") and closed-end funds, with combined assets as of May 31, 2018, of approximately $454.2 billion. Invesco and its affiliates are indirect, wholly-owned subsidiaries of Invesco Ltd., a leading independent global investment management firm, with approximately $977.3 billion in assets under management as of May 31, 2018. Invesco Ltd. manages assets across the globe through a wide range of investment strategies and vehicles, including mutual funds, closed-end funds, ETFs, unit investment trusts ("UITs"), collective trusts, separately managed accounts, real estate investment trusts, private funds and commodity pools, among others.

Invesco supports the Commission's efforts to improve audit quality and efficiency through improvements to the "loan provision" of the auditor independence rules.[2] The Commission's proposed amendments to the loan provision recognizes that the loan provision is not functioning as intended in some circumstances and that the time and resources required to comply with the loan provision in those instances are not commensurate with the protection it offers. Further, the Commission observes that it is clear that instances of noncompliance in a variety of actual settings do not result in an impairment of the auditor's objectivity and impartiality.

We join the Commission's effort to re-examine the loan provision, its objectives and its continued effectiveness. Our comment letter – broadly speaking – is divided into three main parts. The first part discusses the Commission's proposed amendments and generally expresses our support while recommending enhancements that we believe will be helpful to auditors. The second part proposes an alternative formulation of the loan provision in response to the Commission's request for comment on alternatives to the proposed amendments that should be considered. The third part of the letter discusses how we propose to analyze the loan provision. In addition to discussing these three key points, we also discuss certain unintended consequences arising from the scope of the loan provision and recommend certain enhancements to the Commission's rules to address those concerns.

I. Executive Summary

The Commission's auditor independence rules set forth a non-exclusive set of relationships deemed to impair an auditor's objectivity and impartiality. Such relationships include certain direct financial relationships between an accountant and audit client and other circumstances where the accountant has a direct or indirect financial interest in the audit client. In particular, Rule 2-01(c)(1)(ii)(A) (the "loan provision") generally provides that an auditor is not independent when the accounting firm, any covered person in the accounting firm (*e.g.*, the audit engagement team and those in the chain of command), or any of the covered person's immediate family members has any loan (including any margin loan) to or from an audit client, an audit client's officers, directors, or record or beneficial owners of more than 10 percent of the audit client's equity securities.

The Commission's 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

[1] *See Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships*, SEC Release Nos. 33-10491; 34-83157; IC-33091; IA-4904 [83 Fed. Reg. 20753 (May 8, 2018)] (hereinafter the "Proposing Release"), available at https://www.gpo.gov/fdsys/pkg/FR-2018-05-08/pdf/2018-09721.pdf.

[2] *See* Rule 2-01(c)(1)(ii)(A) of Regulation S-X [17 C.F.R. § 210.2-01(c)(1)(ii)(A)] (loans and debtor-creditor relationships).

"audit client" for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client. In addition, the Commission requests comment on alternative approaches to its proposed amendments.

Invesco strongly supports the Commission's proposed amendments as well as the guidance included in the Proposing Release that describes how the proposed amendments would apply to fund audit clients. However, we have identified a number of issues that we believe the Commission should address in any final rule. Our recommendations, which are more fully discussed in this letter, are as follows:

- Invesco recommends that the Commission adopt a provision for assessing materiality in the loan provision.
- Invesco recommends excluding other companies within the same investment company complex from the scope of the loan provision.
- Invesco supports the Commission's proposal to eliminate record owners from the scope of the loan provision.
- Invesco recommends clarifying that a beneficial owner is a person that has a pecuniary interest in the audit client.
- Invesco supports the replacement of the existing 10 percent bright-line test with a "significant influence" test.
- Invesco submits that ASC 323 – Investments – Equity Method and Joint Ventures is not an appropriate framework for analyzing "significant influence" under the loan provision.
- Invesco believes the adopting release should reaffirm the proposing release's guidance on how the significant influence test applies to funds.
- Invesco recommends substituting the "known through reasonable inquiry" standard with a "known" standard.

  Invesco believes the Commission should endorse a flexible framework for evaluating compliance with the loan provision.

In addition, Invesco believes it has identified certain inconsistencies between the scope of the loan provision and other provisions of the auditor independence rules. We believe that our recommendations, and our proposed alternative, will both simplify the analytical framework of the loan provision and enhance investor protection by articulating the specific threats lending relationships pose to an auditor's independence and refocusing the independence analysis on the lender's ability to influence the auditor (rather than on the lender's ability to influence the audit client). A discussion of each of the above matters follows.

II. Comments on the Proposed Amendments to the Loan Provision of Regulation S-X

A. Invesco Supports the Commission's Proposal to Eliminate Record Owners from the Scope of the Loan Provision

The loan provision of Regulation S-X provides that an auditor is not independent if it has a lending relationship with an entity having record or beneficial ownership of 10 percent or more of the equity securities of an audit client.[3] Invesco strongly supports the Commission's proposal to eliminate record owners from the scope of the loan provision. The Commission's approach recognizes that lenders that hold an audit client's equity securities of record have no financial incentive to influence the auditor or the audit client since record owners do not benefit from the performance of the equity securities registered in their name.

With the advent of the indirect holding system for publicly traded securities and the "dematerialization" of fund shares, record ownership of such securities is concentrated in a relatively small number of banks, trusts, broker-dealers, custodians, third-party recordkeepers and other financial intermediaries that hold shares on behalf of their customers in aggregate or "omnibus" accounts.

Since record ownership in this context merely serves a recordkeeping function to facilitate the efficient transfer of securities among issuers and the record owner's clients, we believe any threat to an auditor's independence arising from a lending relationship between an auditor and a record owner of 10 percent or more of an issuer's equity securities to be remote.

B. Invesco Recommends Clarifying that a Beneficial Owner is a Person that has a Pecuniary Interest in the Audit Client

The term "beneficial owner" is not defined under the loan provision or any other provision of Regulation S-X. In the absence of a definition of "beneficial owner," auditors must look to other principles under the federal securities laws for guidance. But the definition of "beneficial owner" under other precepts of law are not necessarily equivalent in scope. For example, under Rule 13d-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") the term "beneficial owner" of a security includes any person who, directly or indirectly, has or shares (1) voting power, which includes the power to vote, or to direct the voting of, such security; and/or, (2) investment power, which includes the power to dispose, or to direct the disposition of, such security.[4] By contrast, under Rule 16a-1 under the Exchange Act, the term "beneficial owner" means any person who, directly or indirectly, has or shares a direct or indirect "pecuniary interest" in an equity security.[5]

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[3] *See* Rule 2-01(c)(1)(ii)(A) of Regulation S-X [17 C.F.R. § 210.2-01(c)(1)(ii)(A)] (accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loan to or from record or beneficial owners of more than 10 percent of the audit client's equity securities). *See also* Rule 2-01(f)(6) [17 C.F.R. § 210.2-01(f)(6)] (defining "audit client" as the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client). Regulation S-X does not define the term "beneficial owner."

[4] *See* Rule 13d-3(a) under the Exchange Act [17 C.F.R. § 240.13d-3(a)] (defining "beneficial owner" for purposes of Sections 13(d) and 13(g) under the Exchange Act [15 U.S.C. § 78m(d), (g)] (requiring certain reports by persons acquiring more than 5 percent of a class of equity securities registered under the Exchange Act).

[5] *See* Rule 16a-1(a)(2) under the Exchange Act [17 C.F.R. § 240.16a-1(a)(2)] (defining "beneficial owner" of a class of equity securities for certain purposes).

Situations frequently arise where a financial intermediary that is the record owner of a security has the power to vote or to direct the voting of that security. For example, New York Stock Exchange Rule 452 allows brokers to vote on certain routine, uncontested matters if the broker has not received voting instructions from its clients within 10 days of an annual meeting.[6] In the absence of clarification, auditors may find Rule 13d-3 under the Exchange Act dispositive, and accordingly, conclude such record owners are "beneficial owners" for purposes of the loan provision.[7] As the Commission observed in the Proposing Release, however, record owners with discretion to vote shares on behalf of their beneficial owners have low incentive to affect the report of an auditor.[8]

We recommend clarifying that the term "beneficial owner" means a person who has a financial or "pecuniary" interest in the audit client for purposes of the loan provision. Without such a clarification, the loan provision will remain over inclusive and will frustrate the objective of the proposed amendments by requiring auditors to devote substantial time and resources to identifying and assessing relationships that do not threaten the auditor's independence.

C. Invesco Supports the Replacement of the Existing 10 Percent Bright-line Test with a "Significant Influence" Test

Under the loan provision, an auditor's independence is impaired if it has a lending relationship with an entity that is the record or beneficial owner of more than 10 percent of an audit client's equity securities. In adopting the 10 percent threshold, the Commission reasoned based on other aspects of the federal securities laws that a lender owning more than 10 percent of an audit client's securities would be considered to be in a position to influence the policies and management of that client.[9] This bright-line approach to ascertaining the scope of those debtor-creditor relationships that pose a threat to an accounting firm's independence is also consistent with the rules of professional organizations such as the American Institute of Certified Public Accountants ("AICPA") and the Public Company Accounting Oversight Board ("PCAOB").[10]

In the Proposing Release, the Commission expresses concern that the current bright-line test is both over- and under-inclusive as a means of ascertaining whether a lending relationship poses a threat to the auditor's objectivity and impartiality. The Commission believes that replacing the existing 10 percent test with a significant influence test will more effectively identify shareholders with the ability to influence an audit client and therefore better suited to identifying relationships that may impair an auditor's independence. We agree.

The significant influence test will require an assessment of lending relationships based on the totality of the facts and circumstances and therefore achieves the dual objectives of enhancing investor protection by capturing potentially conflicted lending relationships with shareholders that own 10 percent or less of the audit client's equity securities and alleviating the compliance burdens on auditors and their clients by eliminating the necessity of scrutinizing immaterial lending relationships merely because the lender's ownership of an audit client's equity securities exceeds an arbitrary threshold.

D. ASC 323 – Investments – Equity Method and Joint Ventures is Not an Appropriate Framework for the "Significant Influence" Test

Invesco supports substituting the 10 percent test with a "significant influence" test but has strong reservations about tying the analytical framework to ASC 323 – Investments – Equity Method and Joint Ventures ("ASC 323"). ASC 323 provides that a direct or indirect investment in 20 percent or more of the voting stock of a company leads to a presumption that in the absence of "predominant evidence to the contrary" an investor has the ability to exercise significant influence over that company.[11] In substance, ASC 323's presumption substitutes a new 20 percent bright-line test for the existing 10 percent bright-line test. Accordingly, interpreting "significant influence" consistent with ASC 323 will perpetuate the costly and burdensome process of producing and analyzing a vast amount of data to determine whether any of an auditor's lenders beneficially own 20 percent or more of an audit client's equity securities.

We also note that "significant influence" under ASC 323 was designed to determine whether to apply the equity method of accounting for purposes of financial statement reporting. But our objective here is to determine whether an auditor's objectivity is impaired in fact or in appearance by a lending relationship. We have serious concerns about using an analytical framework developed in a completely different context to address the issues at hand.

Our concerns are particularly acute when the audit client is an investment company. For fund audit clients, application of ASC 323 will likely lead to additional complexity and confusion since ASC 323's "significant influence" criteria is designed for operating companies. We propose instead that the Commission adopt a decision framework with a singular focus on the beneficial owner's ability to exert significant influence

[6] *See* New York Stock Exchange (NYSE) Rule 452. We note that NYSE Rule 452 authorizes member organizations to give a proxy to vote without instructions from the beneficial owner if the proposal relates to the election of directors of a company registered under the Investment Company Act of 1940, as amended (the "1940 Act").

[7] Conversely, the lack of clarity may cause other audit firms to conclude that a person that merely has the power to vote a security is not a "beneficial owner" within the meaning of the loan provision thereby creating inconsistent practices within the industry.

[8] *See* Proposing Release at text surrounding note 58 (observing 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"). *See also* Proposing Release at 20766 (observing the "magnitude of a party's investment in a company or fund is likely to be positively related with any incentive . . . to use leverage over the auditor with whom the party has a lending relationship").

[9] *See Revision of the Commission's Auditor Independence Requirements*, SEC Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911 [65 Fed. Reg. 76007(Dec. 5, 2000) at 76035] (hereinafter the "2000 Adopting Release"), available at https://www.gpo.gov/fdsys/pkg/FR-2000-12-05/pdf/00-30244.pdf.

[10] *See AICPA Code of Professional Conduct*, available at https://pub.aicpa.org/codeofconduct/Ethics.aspx#. *See also* PCAOB Rule 3500T, available at https://pcaobus.org/Rules/pages/section_3.aspx#rule3500t (adopting interim ethics standards consistent with those of the AICPA's *Code of Professional Conduct*).

[11] *See* ASC 323-10-15-8. In practice, rebutting a presumption of significant influence under ASC 323 is extremely challenging as auditors are faced with proving a negative. This presumption is rarely – if ever – challenged in practice.

over the audit client's operating and financial policies, based on the totality of the facts and circumstances, and avoid the complications that could result from reliance on the ASC 323 framework.

If the Commission declines to accept our recommendation to disassociate the "significant influence" test from ASC 323, we believe the adopting release should confirm that evaluation of an audit client's governance structure is sufficient to rebut any presumption of significant influence under the ASC 323 framework. Rebutting a presumption of significant influence under ASC 323 is extremely challenging and is rarely – if ever – overcome in practice. But in cases where a lender does not have the ability to exercise significant influence over the audit client's operations or financial policies due to the audit client's governance structure, the interests of securityholders will not be served by a compulsory review of the lender's ownership interests, which would be required under the ASC 323 framework. We do not believe that the Commission intended such an outcome in proposing to replace the existing 10 percent bright-line test with the significant influence test. Instead, we believe the Commission intended auditors to consider the totality of the facts and circumstances surrounding its lending relationships. Accordingly, we urge the Commission to confirm that if an auditor concludes that a lender does not have the ability to exert significant influence over an audit client based on an evaluation of the audit client's governance structure then there is sufficient evidence to rebut any presumption of significant influence that could arise under ASC 323, and therefore, there is no need to further analyze whether a lender is a beneficial owner of an audit client's equity securities.[12]

E. The Adopting Release Should Reaffirm the Proposing Release's Guidance on the Significant Influence Test in the Fund Context

We appreciate the Commission's thoughtful guidance on the applicability of the significant influence test to the unique circumstances fund audit clients face and believe that reaffirming this guidance in the adopting release will be helpful both to accounting firms and fund audit committees in administering the audit engagement.

The Proposing Release states that, in the fund context, the operating and financial policies relevant to the significant influence test 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").[15] The Proposing Release further states that an audit firm could analyze whether significant influence over a fund's portfolio management processes exists by evaluating the fund's governance structure, governing documents, distribution arrangements and contractual arrangements, among other relevant factors.[16]

As the Proposing Release points out, significant influence generally does not exist under circumstances where the investment advisory agreement, governing documents and applicable law delegate significant discretion with respect to a fund's portfolio management processes to its investment adviser and board of directors.[17] The Proposing Release also notes that the ability to vote on the approval of a fund's investment advisory contract or fundamental investment policies on a *pro rata* basis with all other fund shareholders should not constitute significant influence in and of itself but instead should be one of many factors to consider as part of the analysis.[18]

We strongly agree with the Commission's approach. It provides a clear and intuitive way for auditors to apply the concept of significant influence without relying on ASC 323, and is particularly helpful with respect to fund audit clients, which unlike operating companies, generally do not have employees, but instead rely on contracts with numerous third parties including investment advisers, principal underwriters, custodians, transfer agents and administrators, among others. We agree with the Commission that the mere ability to vote on a proposal *pro rata* with other shareholders is not indicia of significant influence.[19] We therefore strongly urge the Commission to affirm the guidance set forth in the Proposing Release with respect to how the significant influence test applies to fund audit clients.

F. Invesco Recommends that the Commission Adopt a Provision for Assessing Materiality in the Loan Provision

We strongly recommend that the Commission adopt a final rule that provides an auditor's independence is impaired only if a loan is material to the auditor. Incorporating a materiality assessment in the loan provision will benefit auditors, issuers and investors in two important ways. First, a materiality threshold will encourage auditors to structure their lending relationships in ways that do not implicate the loan provision. Second, a materiality threshold will limit the number of lending relationships that auditors must evaluate. Together, the benefits of a materiality assessment will significantly reduce administrative burdens without increasing the threat of undue influence on the auditor.[22]

This proposal is consistent with the Commission's objective of identifying the appropriate scope of those relationships that could impair an auditor's independence. Other provisions of the Commission's auditor independence rules recognize that the threat of undue influence is remote when a financial interest is not material to the auditor. For example, an auditor's independence is impaired if the accounting firm, any

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[12] We discuss this recommendation in more detail in connection with our proposed analytical framework for auditor lending relationships. See Section IV beginning on p. 8.
[15] *See* Proposing Release at 20761.
[16] *Id.*
[17] *Id.*
[18] *Id.* (stating the "ability to vote on the approval of a fund's advisory contract . . . alone generally should not lead to the determination that a shareholder has significant influence" but also noting that "if a shareholder in a private fund . . . has a side letter agreement outside of the standard partnership agreement that allows for participation in portfolio management processes . . . then the shareholder would likely have significant influence").
[19] In the case of operating companies, for example, the power to vote on a fundamental organizational or governance change such as a merger does not in and of itself indicate the existence of significant influence. Likewise, the power to vote on a proposal to approve or terminate an investment advisory agreement or to approve the continuation of a distribution agreement in accordance with Section 15 of the 1940 Act [15 U.S.C. § 80a-15] or to approve or terminate a plan of distribution adopted in accordance with Rule 12b-1 under the 1940 Act [17 C.F.R. § 270.12b-1] is analogous to the ability of a shareholder of an operating company to vote on similar fundamental governance and organizational issues.
[22] An auditor should discuss its assessment of its material lending relationships with audit committees, which are responsible for the administration of the audit engagement. *See* PCAOB Rule 3526.

covered person in the firm, or any of their immediate family members has a "material indirect investment" in an entity where that entity "has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client."[23] Under this provision of the auditor independence rule, the threat of undue influence and self-interest are remote when an indirect investment is not material to the auditor. Any threat to an auditor's independence arising from a lending relationship with a shareholder that is the beneficial owner of an audit client's equity securities is even more remote. Accordingly, we believe that the loan provision should be subject to similar materiality thresholds.

If the Commission adopts a materiality qualifier to the loan provision, the auditor's assessment of whether a loan is "material" should be based on the facts and circumstances, including, but not limited to (1) whether the debt is in good standing; (2) whether the lender has the right to take action against the auditor in the absence of a default; (3) whether the size of the balance is significant to the auditor; (4) whether the auditor has controls to insulate its finance function from its audit function; (5) whether the auditor has access to diverse financing sources; (6) whether the lender has extended credit on market terms; (7) whether the loan is originated by a single lender or a syndicate of lenders; (8) whether the lender has any relationships with the audit client's audit committee members; and (9) the purpose of the loan (*e.g.,* working capital, to finance a new partner's buy-in to the firm, or to finance a consumer transaction).

G. Invesco Recommends Substituting the "Known Through Reasonable Inquiry" Standard with a "Known" Standard

The Commission requests comment on whether the loan provision should include a "known through reasonable inquiry" standard with respect to identifying beneficial owners to help address compliance challenges associated with the loan provision. The Proposing Release acknowledges the difficulty in accessing information regarding the ownership percent of an audit client for purposes of the loan provision.[24] In many instances, shares of publicly traded securities (including those of registered investment companies) are held in the name of a nominee in aggregated omnibus accounts. In some cases, there may be multiple tiers of omnibus accounts, which increases the complexity and difficulty of obtaining the information necessary to assess compliance with the loan provision. It may even be impossible in certain cases to identify the beneficial owner of the shares of an audit client.[25]

We thank the Commission for proposing amendments to address these compliance challenges. However, we believe that the addition of a "known through reasonable inquiry" standard unnecessarily complicates the analysis for auditors. The Proposing Release states that audit firms and their clients would be required to analyze beneficial owners of the audit client's equity securities that are known through "reasonable inquiry" without specific guidance as to what measures satisfy this standard. In practice, such a standard will be difficult for auditors to apply on a consistent basis because different financial intermediaries that hold shares of an audit client may have varying contractual or regulatory obligations to provide (or withhold) information about beneficial owners of the audit client's shares. Thus, the ability of an auditor to obtain information about the beneficial owners of a client's shares and the complexity of that process will depend on the mix of its client's financial intermediaries.

To alleviate the complexity of a "known through reasonable inquiry" standard and to promote consistency across the industry, we recommend substituting a "known" standard in place of the "known through reasonable inquiry" standard. The threats to an auditor's independence arising in a debtor-creditor relationship (*i.e.,* self-interest and undue influence) can impair the auditor's objectivity and impartiality only if the auditor is aware that its lender is the beneficial owner of an audit client's equity securities.

Our proposed "knowledge" standard is also consistent with other provisions of the auditor independence rules. Regulation S-X provides that an accounting firm's independence is not impaired if a covered person is not independent if the firm has adopted certain quality controls and the covered person "did not know of the circumstances giving rise to the lack of independence."[26] In addition, in the 2000 Adopting Release, the Commission raised the record and beneficial ownership threshold of the loan provision from 5 percent as proposed to 10 percent reasoning that the 10 percent threshold is consistent with certain public reporting requirements under the federal securities laws, which would enable auditors to monitor compliance with the loan provision more effectively.[27]

If the Commission adopts a "known" standard, we urge the Commission to further clarify that a person is "known" to be a beneficial owner of an audit client's equity securities if and only if the auditor has actual knowledge of the lender's beneficial ownership interest or the lender has disclosed its beneficial ownership interest in a public filing with the Commission.[28]

H. The Commission Should Endorse a Flexible Framework for Evaluating Compliance with the Loan Provision

Under Regulation S-X, an accountant is not independent if the accountant's independence is impaired at any point during the audit and professional engagement period. The Commission requests comment on whether the loan provision should provide that auditor independence may be assessed on specific dates during the engagement. The Proposing Release states that if an auditor determines that significant influence does not exist based on the facts and circumstances at the time of the auditor's initial evaluation, the auditor should

[23] *See* Rule 2-01(c)(1)(i)(E)(1)(ii) of Regulation S-X [17 C.F.R. § 210.2-01(c)(1)(i)(E)(1)(ii)] (addressing certain investments in audit clients).
[24] *See* Proposing Release at 20757.
[25] *See id.* at note 63 (noting that under Exchange Act rules issuers cannot obtain information about beneficial owners that have objected to providing information to the issuer).
[26] *See* Rule 2-01(d)(1) of Regulation S-X [17 C.F.R. § 210.2-01(d)(1)].
[27] *See* 2000 Adopting Release at 76035 (increasing the loan provision threshold from 5 percent to 10 percent because "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").
[28] An auditor's review of such flings (*e.g.,* Form 10-K, Schedule 14A, Schedule 13D, and Schedule 13G) will enable the auditor to ascertain whether a lender has a beneficial ownership interest that must be reviewed.

monitor the loan provision on an ongoing basis.[29] However, as the Commission recognizes in the Proposing Release, monitoring compliance with the loan provision on an ongoing basis presents significant compliance challenges.[30]

In the context of the loan provision, we believe that the Commission should adopt a flexible framework for evaluating compliance during the engagement period. Under this approach, an auditor's independence would not be impaired provided the accounting firm has adopted written policies and procedures reasonably designed to detect and prevent violations of the loan provision. Such procedures would be reasonably designed if the procedures require the firm to evaluate compliance with the loan provision at the beginning of the engagement and prior to accepting any new engagement and when the governance structure (including any contractual relationships) of the audit client changes.

I. The Commission Should Consider Modifying the Specific Types of Loans that Do Not Implicate the Loan Provision

We believe that the proposed amendments to the loan provision under the auditor independence rules will realign the rule with its intended purpose. However, even if the Commission adopts a final rule that incorporates all of the proposals discussed herein, there may be certain instances where the loan provision continues to be significantly over inclusive. The Commission should consider using this rulemaking opportunity to address these concerns.

1. Insurance Company Separate Accounts

Funds frequently serve as the underlying funding vehicle for variable annuity contracts and variable life insurance policies (collectively, "variable products") issued by life insurance companies to their clients. Variable products represent interests in segregated asset accounts ("separate accounts") registered as unit investment trusts under the 1940 Act. Under state law, separate accounts are not legal entities distinct from the insurer. Instead, insurers are the legal and beneficial owners of the fund shares underlying the variable products they issue.

Frequently, funds underlying variable insurance products are dedicated to such products. Consequently, insurers often own beneficially and of record large positions in such funds. From time to time, insurers enter into lending relationships with audit firms. Such relationships have the potential to impair the auditor's independence because auditors may be unable to conclude that the insurer does not have "significant influence" over an underlying fund audit client. We note that even if the Commission accepts our proposed definition of "beneficial owner," which would require that the securityholder have a "pecuniary interest" in the audit client's equity securities, insurers receive financial benefits from holding fund shares in their separate accounts even though the income and capital gains or losses are attributable to a variable product owner's account. For example, insurers may receive a dividend received deduction or foreign tax credit benefits that accrue to the benefit of the insurer and are not passed through to policyholders. Variable products may also include certain kinds of death benefits, living benefit guarantees or "free-look" periods that expose the insurer to the risks associated with a direct investment in the underlying funds.

The threats posed by lending relationships with insurers that are the sponsors or depositors of separate accounts that issue variable insurance products are nevertheless remote. In order to invest in the shares of underlying funds, insurers typically rely on a provision of the 1940 Act that requires the insurer either to seek instructions from its securityholders with regard to the voting of all proxies with respect to such security and to vote such proxies only in accordance with such instructions ("mirror voting"), or to vote the shares held by it in the same proportion as the vote of all other holders of such security ("echo voting").[31] In addition, the 1940 Act prohibits an insurer from substituting an underlying fund for another underlying fund unless the insurer has obtained an order from the Commission.[32]

In light of these circumstances, we recommend that the Commission amend the loan provision to explicitly exclude loans from insurance companies that are made in accordance with the insurer's usual lending practices and that would impair the independence of an accounting firm solely by reason of the insurer acting as the sponsor of, or depositor for, separate accounts registered as unit investment trusts under the 1940 Act. This position would also be consistent with recent no-action letters issued by the Division of Investment Management.[33]

2. Fully Collateralized Loans

We also recommend that the Commission rationalize the exclusion for fully collateralized loans made under a lender's normal procedures, terms and requirements.[34] In particular, we recommend that the Commission expand the exclusion to include all fully collateralized loans. It is not clear why the rule currently excludes only the specified collateralized loans and not all collateralized loans. Collateralized loans are fully backed by their underlying assets such that an audit firm or its covered persons (or immediate family members of covered persons) are unlikely to be subject to undue influence from a lender with regard to terms of the loan.

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[29] *See* Proposing Release at 20761.
[30] *Id.*
[31] *See* Section 12(d)(1)(E)(iii)(aa) of the 1940 Act [15 U.S.C. § 80a-12(d)(1)(E)(iii)(aa)]. We note that it may also be appropriate to exclude other lending relationships where the lender has irrevocably relinquished their right to vote shares (*e.g.*, certain banks holding preferred shares of closed-end funds may create irrevocable voting trusts).
[32] *See* Section 26(c) of the 1940 Act [14 U.S.C. § 80a-26(c)] (prohibiting a registered unit investment trust from substituting the securities of an issuer with the securities of another issuer unless substitution is approved by the Commission).
[33] *See e.g., Fidelity Management & Research Company*, No-Action Letter (June 20, 2016), available at https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm.
[34] *See* Rule 2-01(c)(1)(ii)(A)(1) through (4).

Further, we recommend that the Commission exclude loans that are not material to the net worth of a covered person or immediate family members of a covered person. In particular, the Commission could consider adding a *de minimis* exclusion for loans that are unlikely to impair a covered person or audit firm's objectivity and impartiality.[35]

III. Proposed Alternative to the Commission's Amendments to the Loan Provision of Regulation S-X

Invesco appreciates the opportunity to express its strong support for the Commission's proposed amendments to the loan provision of Regulation S-X. We agree that the loan provision does not function as intended. We have discussed our support for the Commission's proposal and provided comment on ways in which the Commission could enhance the final rule to achieve its objective. However, Invesco believes that this rulemaking is also an opportunity for the Commission to enhance investor protections while adopting a substantially simpler approach to conflicts that arise in the context of an accounting firm's lending relationships. We discuss this proposed alternative approach below.

A. Discussion of Threats Presented by Auditor Lending Relationships

The auditor independence rules are designed to ensure that auditors are qualified and independent in both fact and in appearance. In adopting these rules, the Commission has stated its commitment to the principle that independent auditors have an important role in protecting the public trust. Fostering investor confidence requires not only that auditors actually be independent of their audit clients, but also that investors perceive them to be independent. These precepts are echoed in the AICPA's *Code of Professional Conduct* pursuant to which auditors must identify threats to their objectivity and impartiality, evaluate the significance of those threats and apply safeguards to reduce those threats to an acceptable level.[36]

There are two principal threats presented by an auditor that has a lending relationship with an entity that has a financial interest in an audit client. Today, the Commission's rules address the threat of undue influence. Undue influence may arise in situations where an auditor's objectivity is subordinated to a lender with a financial interest in the audit client because the loan is material to the auditor or because the lender has the ability to influence the auditor's objectivity by changing the terms upon which the lender extends credit to the auditor.[37]

The second principal threat that arises in the context of a lending relationship is the threat of self-interest. Self-interest may impair an auditor's objectivity if the auditor seeks to cultivate a financial benefit from a lender through the auditor's relationship with an audit client in which the lender has a financial interest.[38] In this respect, the loan provision of the auditor independence rule is under-inclusive with respect to lenders associated with an audit client through its ownership of the audit client's securities. Specifically, only shareholders that own the "equity securities" of an audit client are in scope.[39] However, the self-interest threat remains present even if a lender is associated with an audit client through investments in the audit client's bonds, notes, or other non-equity securities.[40]

The threats posed by an auditor's self-interest in a lending relationship have been addressed in other contexts. The AICPA's Independence Rule provides that independence may be impaired if an auditor "has a loan to or from any individual owning 10 percent or more of the attest client's outstanding equity securities *or other ownership interests*" (emphasis added).[41] The Commission has also recognized self-interest as a concern with respect to lending relationships.[42]

This rulemaking presents an opportunity for the Commission and the industry to re-evaluate the loan provision, its objectives and its continued effectiveness. We believe that the alternative we propose today will both simplify the analytical framework of the loan provision and enhance investor protection by refocusing on, and directly addressing, the threats lending relationships pose to the objectivity and independence of the auditor rather than the audit client.

B. The Loan Provision is a Special Application of the Independence Rules that Govern Financial Interests between Accounting Firms and their Audit Client

Our proposal begins with the recognition that the loan provision is a special application of existing independence rules that govern direct and material indirect financial interests between accounting firms and their audit clients. Regulation S-X provides that an auditor is not independent when the "audit client" has any direct investment in the accounting firm, such as stock, bonds, notes, options or other securities.[43] The term "audit client" is defined as the entity whose financial statements are being audited *and any affiliates of the audit*

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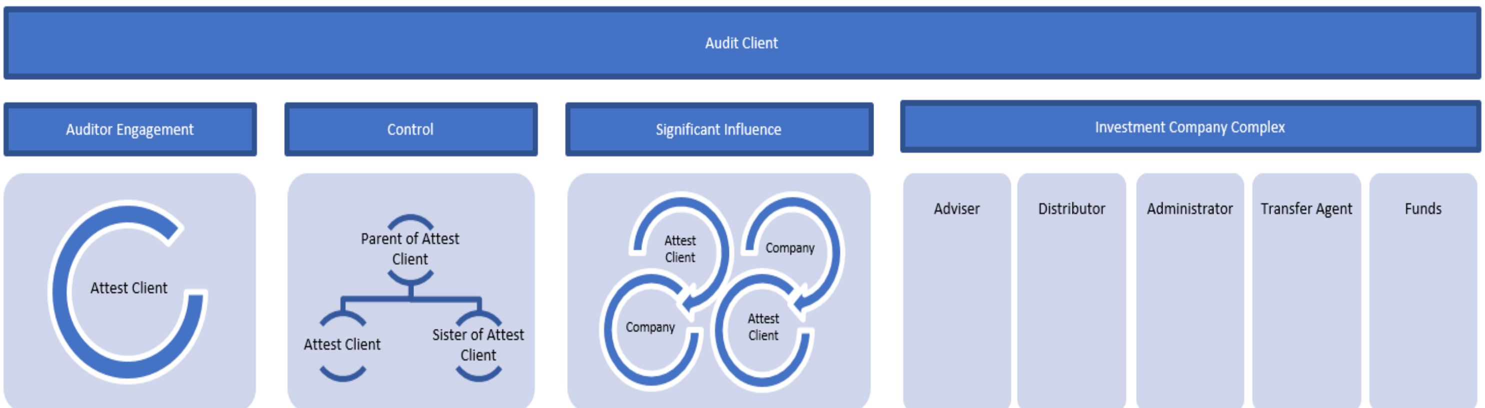
[35] We note that current Rule 2-01(c)(ii)(E) provides that an accountant is not independent if it owes a lender a credit card balance of more than $10,000. We recommend that the Commission specify that loan balances to covered persons or their immediate family members under $10,000 are also de minimis.
[36] AICPA *Code of Conduct* at ET sec. 1.000.010 (Conceptual Framework for Members in Public Practice).
[37] For example, a lender could seek to influence an auditor by revoking an uncommitted line of credit, calling an outstanding loan, impairing the creditworthiness of the auditor or increasing the interest and fees associated with the loan. We note that a lender's power to exert this sort of coercion may be enough to influence an auditor even if the lender does not in fact exercise its power. Thus, even if the auditor's independence is not impaired *in fact* the auditor's independence is impaired *in appearance*.
[38] For example, the auditor may seek to obtain a significant loan from a lender associated with an audit client or may seek to obtain financing on terms more favorable than those available from other lending institutions.
[39] *See* Rule 2-01(c)(1)(ii)(A) (prohibiting an auditor from accepting a loan from owners of more than 10 percent of the audit client's *equity securities*).
[40] *See AICPA Code of Professional Conduct* at ET sec. 0.300.070 (defining "financial interest" to include ownership interests in debt securities as well as "rights and obligations to acquire equity or debt securities and derivatives directly related to such interest").
[41] *See id.* at ET sec. 1.260.010.
[42] *See* 2000 Adopting Release at 76060 (a significant influence test "sets a proper baseline threshold for audit client affiliation because, under the equity method of accounting, it results in the marriage of financial information between the audit client and the entity influenced by, or influencing, the financial or operating policies of the audit client") (footnotes omitted). The equity method of accounting provides a self-interest incentive for the company with influence over the other to engage in improper conduct.
[43] *See* Rule 2-01(c)(1)(iv)(A) of Regulation S-X [17 C.F.R. § 210.2-01(c)(1)(iv)(A)] (discussing investments by an audit client in its accounting firm).

client.[44] For purposes of the loan provision, an affiliate of an audit client includes (1) 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; (2) an entity over which the audit client has *significant influence* (unless the entity is not material to the audit client); (3) an entity that has *significant influence* over the audit client (unless the audit client is not material to the entity); and (4) each entity in an investment company complex when the audit client is an entity that is part of an investment company complex ("ICC").[45] If the amendments to the loan provision were adopted as proposed, an auditor would not be independent if it has a loan from a beneficial owner of the audit client's equity securities where the beneficial owner has *significant influence* over the audit client. As illustrated by Figure 1, however, an entity that has "significant influence" over the audit client is generally an affiliate of the audit client and is therefore prohibited from having any investment in the auditor, including in the auditor's debt securities.[46]

Figure 1



For purposes of assessing whether an auditor is independent under the loan provision, we believe that an audit client's investment in the bonds or notes of its auditor is the functional equivalent of a loan. We nevertheless recognize that loans are distinguished from securities under the federal securities laws and therefore the provisions of the loan rule discussed above may not technically violate the Commission's independence rules.[47] We believe the Commission should address this inconsistency.

C. Discussion of Inconsistencies Between the Scope of the Loan Provision and Other Provisions of the Auditor Independence Rules

If the proposed amendments to the loan provision were adopted as proposed, a lender that has significant influence over an audit client could conceivably extend credit to an auditor without impairing the auditor's independence by structuring the transaction as the purchase of a note or bond rather than as a loan.[48] Since the transaction is not a "loan" the loan provision is not implicated. If the audit client is not material to the lender, then the lender is not an affiliate of the audit client and is therefore outside the scope of the rule against investments by an audit client in its accounting firm. Figure 2 illustrates how the existing auditor independence rules apply to the scenario described above compared to our proposed alternative discussed in Section III beginning on p. 7.

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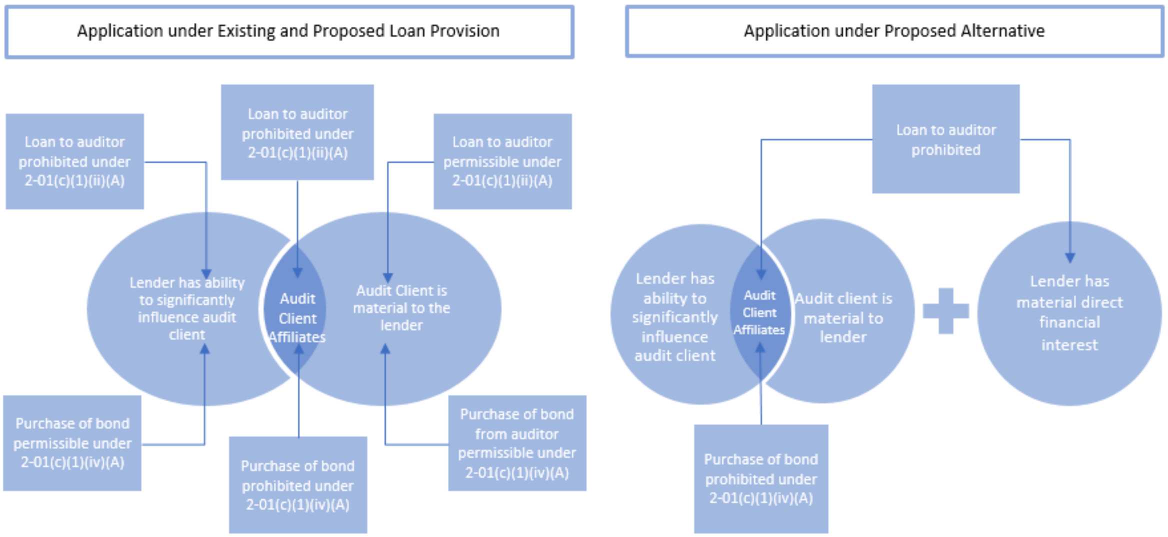
[44] *See* Rule 2-01(f)(6) of Regulation S-X [17 C.F.R. § 210.2-01(f)(6)] (defining "audit client"). *See also* Rule 2-01(f)(4) of Regulation S-X [17 C.F.R. § 210.201(f)(4)] (defining "affiliate of the audit client").
[45] *Id.*
[46] *Id.* A significant difference between the loan provision and the prohibition on an audit client's direct investment in an auditor is that the term "audit client" includes a lender with a significant influence over the audit client only if the audit client is material to the lender. As the loan provision is presently constituted, a loan from a beneficial owner with significant influence over the audit client would impair the auditor's independence regardless of whether the audit client was material to the lender. We discuss the issues posed by this distinction in Section III.C beginning on p. 7.
[47] In *Reves v. Ernst & Young*, 110 S. Ct. 945 (1990), the Supreme Court adopted a "family resemblance" test to distinguish a promissory note issued and purchased for investment purposes, and thus a security, from those issued and purchase for some other purpose, which are not. Under this test, there is a rebuttable presumption that a note is a security, but the Court recognized particular categories of notes that are not securities including: a note delivered in consumer financing, a note secured by a mortgage on a home, a note secured by a lien on a small business or some of its assets, a note relating to a "character" loan to a bank customer, a note that formalizes an open-account indebtedness incurred in the ordinary course of business, a short-term note secured by an assignment of accounts receivable and notes given in connection with loans by a commercial bank to a business for current operations.
[48] This result also holds if the Commission determines not to adopt any proposed amendments to the loan provision.

Figure 2



We do not believe that the Commission intended to allow auditors and lenders to pick and choose the applicable standard of conduct simply by restructuring their transactions as either loans or investments depending on the more advantageous independence rule.[49] However, as the Commission reassesses the scope of the loan provision, we believe it is time to consider whether there is a simpler approach to addressing the self-interest and undue influence conflicts presented by debtor-creditor relationships.

D. Discussion of Invesco's Proposed Alternative

In formulating an alternative approach, our proposal is informed by our comments on the Commission's proposed amendments to the loan provision. We believe that an appropriate alternative will have the following characteristics:

- The analysis should focus on the lender's ability to exert undue influence on the auditor and on the potential for the auditor's self-interest to influence its objectivity.
- A lending relationship that is not material to the auditor will not *per se* impair the auditor's independence.[50]
- The provision will eliminate incentives to structure transactions for the purpose of evading one provision of the independence rules in favor of another.
- The provision will acknowledge that a self-interest threat may persist in certain cases where a lender does not have significant influence over the audit client and will reduce that threat to an acceptable level.
- The provision will be consistent with existing practices and standards of conduct to facilitate the consistent applicability of the rule.
- The provision will have an appropriate scope so as to avoid time consuming and expensive compliance procedures that are not justified with respect to the likelihood or magnitude of the threat to the auditor's objectivity.

In Appendix A, we have included a marked version of our alternative approach to the loan provision under Regulation S-X. In addition, we have included hypothetical examples of the application of our alternative approach in Appendix F. The proposed amendments are summarized and discussed below.[51]

1. *Strike the reference to record or beneficial owners of more than 10 percent of the audit client's equity securities.*

As discussed above, we support the Commission's proposal to replace the 10 percent bright-line test with a significant influence test. We believe that this can be accomplished by striking the reference to record and beneficial owners from the rule. As revised, the loan provision would continue to apply to loans to or from the audit client. In Figure 1, we illustrated that the term "audit client" includes the audit client's affiliates. The term "affiliate" includes "an entity that has significant influence over the audit client" unless the audit client is not material to the entity. In addition to incorporating the proposed "significant influence" test into the loan provision analysis, our proposed materiality assessment is incorporated by definition.[52] We believe that the Commission's guidance on the application of the significant influence test

[49] We note that the Commission has cautioned that the factors described in the auditor independence rules are general guidance only and do not purport to consider all circumstances that raise independence concerns. *See* Preliminary Note to Rule 2-01 of Regulation S-X [17 C.F.R. § 210.2-01]. But whether such conduct would be prohibited under this general rule is ambiguous since two separate provisions of Regulation S-X purport to address these relationships.
[50] We discuss the issue of materiality in detail in Section II.F beginning on p. 3.
[51] The marked changes to the loan provision do not incorporate other provisions that we support and recommend that the Commission adopt (*e.g.,* our recommendation with respect to the scope of certain terms used in the loan provision, the treatment of insurance company separate accounts and the treatment of fully collateralized loans, among others). The scope of our proposal compared to the existing rule is illustrated in Figure 2.
[52] In this regard, our proposal to strike the reference to record and beneficial owners is effectively identical to the Commission's proposal; however, this approach relies on the existing language imbedded in the rule; and therefore, we believe this approach is a more direct way of accomplishing the same objective.

discussed in our comments to the Proposing Release will continue to be relevant if the Commission adopts our proposed alternative, and we strongly recommend that the Commission retain such guidance in any adopting release.

2. *Clarify that an entity that has a material direct financial interest in an audit client is within the scope of the rule.*

In formulating our alternative approach to the loan provision, we noted that self-interest may continue to threaten an auditor's objectivity regardless of whether the lender has the ability to significantly influence the audit client. We further noted that the existing loan provision may not account for such scenarios since it is limited to entities that own the "equity securities" of an audit client. Although Regulation S-X does not define the term "equity security," certain investments that do not grant voting rights to the lender (*e.g.*, preferred stocks, convertible securities, bonds, notes, and options) may nonetheless be material to the lender and lead to unacceptable conflicts of interest.[53] If the Commission adopts a rule that incorporates our proposed amendment, we believe the Commission should reiterate that materiality in this context does not refer exclusively to the accounting or financial significance of the investment to the lender. Instead, auditors should regard an investment as "material" to a lender if a reasonable investor with knowledge of all relevant facts and circumstances would conclude that its objectivity might be impaired or influenced by the investment.

3. *Clarify that a loan that is not material to the auditor is not within the scope of the rule.*

In our comments on the Proposing Release, we strongly recommend that the Commission adopt a final rule that provides an auditor's independence is impaired only if a loan is material to the auditor. We reiterate that a materiality assessment is instrumental in identifying those relationships that could impair an auditor's independence and that the threat of undue influence and self-interest are remote when a loan is not material to the auditor. Our alternative provides that a debtor-creditor relationship that meets the other criteria described above will impair an auditor's independence "unless the loan is not material to the accounting firm, any covered person in the firm, or any of his or her immediate family members." This language is intended to incorporate this critical materiality standard addressed in our earlier comments on the proposed amendments to the loan provision.

IV. Analytical Framework for Auditor Lending Relationships

We believe that auditors would benefit from guidance from the Commission that confirms that auditor lending relationships must be assessed only in so far as the relationship is within the scope of each element of the rule. We recommend that the Commission, in any adopting release, confirm that if an auditor concludes that any one of the necessary elements of the loan provision do not apply, that the analysis need not proceed, and further, that auditors may take the most efficient approach to the analysis of the applicability of the loan provision that suits the circumstances of the particular audit engagement. We discuss this approach first as it relates to the Commission's proposal and second as it relates to our alternative approach. To facilitate the discussion of our proposed analytical framework, we have included a decision tree in Appendix B and Appendix C for the analysis under the proposed loan provision and our alternative approach, respectively.

A. Analytical Framework under the Proposed Loan Provision

The Commission is proposing two amendments that will alter the analytical framework for lending relationships under its auditor independence rules. First, the Commission proposes to focus the analysis on "beneficial owners" instead of "record or beneficial owners." Second, the Commission proposes to eliminate the existing bright-line 10 percent test and replace it with a "significant influence" test. In addition, we have recommended that the Commission enhance the loan provision by adopting a materiality assessment, clarifying that a "beneficial owner" is a person with a financial or "pecuniary" interest in the audit client.[54]

We recommend that the Commission confirm that analysis under the loan provision may be accomplished by following the path of least resistance. For example, in some audit engagements, particularly where the audit client is a fund, auditors may be able to conclude, based solely on a review of the audit client's governance structure, that a lender cannot have "significant influence" over the audit client. If an auditor is able to reach this conclusion with respect to a particular audit client, the auditor should not be required to assess whether it has material lending relationships or to devote resources to determining whether any of its lenders are "beneficial owners" of the audit client's equity securities.

However, auditors may not always be able to infer that lenders cannot have significant influence over an audit client based solely on a review of the audit client's governance structure. This scenario will likely be common when the engagement relates to an audit client that is not a fund or relates to an entity structured as a partnership or limited liability company. In addition, in order to become comfortable that a lender cannot exercise significant influence over an audit client based solely on the client's governance structure, auditors may require opinions of counsel and representations from fund management that may not always be satisfactory to the auditor.

For this reason, we recommend that the Commission's adopting release also confirm that an auditor need not proceed with an analysis of any lending relationship where the loan is not material to the auditor and that analysis of beneficial ownership is required if and only if a loan is material to the auditor and a lender may have the ability to exercise significant influence over the audit client. From this point, auditors should then determine whether to proceed based on whether its material lenders have a "known" financial or "pecuniary" interest in the audit client. If the auditor is not aware of facts that indicate the lender has a material pecuniary interest in an audit client (*e.g.*, the lender merely has the power to vote the audit client's securities), the auditor need not analyze the relationship further. Only if all of the preceding conditions have been satisfied should auditors be required to devote resources to ascertaining whether "significant influence" exists by virtue of the lender's holdings.

[53] This aspect of our proposal simply makes the implicit prohibition of Rule 2-01(b) explicit. See note 49, supra, and surrounding text, generally discussing how lenders could structure transactions to avoid the applicability of the loan provision if such a prohibition were not implicit in the rule.

[54] If the Commission declines to accept our recommendation to dissociate the ASC 323 analytical framework from the "significant influence" test, we supplementally request confirmation that analysis of an audit client's governance structure is sufficient to rebut any presumption of "significant influence" that may arise under ASC 323. We discuss this and other recommendations in detail in Section II of our letter.

B. Analytical Framework under Invesco's Alternative Proposal

If the Commission adopts a final rule incorporating all or some aspects of our alternative proposal, we urge the Commission to adopt an analytical framework similar to the one described above. Under our proposed alternative, an auditor first assesses whether it has any material lending relationships that are not excluded from the scope of the rule. The auditor then considers whether its material lenders are "audit clients" and whether it is aware of any material direct financial interest the lender has in the audit client.[55] If the auditor finds that a material lender is an "audit client" or knows a material lender has a material financial interest in an audit client, the auditor's independence would be impaired under our alternative proposal.

We believe that the analytical framework for our alternative proposal will be simple for auditors to apply. As discussed above, we believe that auditors should be able to readily ascertain whether a lender is material to the firm and if so whether that lender is an "audit client" as defined under Regulation S-X. We note this step of the analysis would require auditors to determine whether a lender has the ability to significantly influence the audit client; however, since auditors are already required to determine whether an entity is an affiliate of an audit client, our approach should not present any additional compliance burdens.

Once the auditor has narrowed the scope of its lending relationships to those that are material to the firm and concluded that its lenders are not deemed to be its "audit client," the final step in the analysis will be to ascertain whether the auditor is aware of any material financial interest the lender has in the audit client. Auditors should be able to readily make this determination by leveraging the "known" standard that we recommend and discuss in detail above.[56]

If the auditor concludes that it does not have any material lending relationships with its audit client and is not aware of any material financial interest of a material lender in its audit client, the undue influence and self-interest threats that arise from the auditor's lending relationships are remote and therefore do not impair the auditor's independence.

V. Scope of the Loan Provision

In Figure 1, we illustrated that the term "audit client" includes the audit client's affiliates and noted that an audit client's affiliates include, among others, an entity that has significant influence over the audit client unless the audit client is not material to that entity. But when the entity under audit is part of an investment company complex ("ICC"), the audit client's affiliates include any company this is part of the ICC, including any other investment company or entity that would be an investment company but for the exclusions provided under Section 3(c) of the 1940 Act (collectively, "funds"), the investment adviser to any such funds, the investment adviser's parent company (and intermediate parent companies if any), any subsidiary of the investment adviser, and other companies affiliated with the investment adviser that provide certain services to funds within the ICC, including a fund's distributor, transfer agent, administrator or depositor.[57]

Under the existing loan provision, an auditor's independence is impaired with respect to every company within an ICC if its independence is impaired with respect to any company within the ICC. The Commission's proposed amendments to the loan provision recognize the far-reaching consequences of the rule that exists today. The scope of those consequences is illustrated in Appendix D. As the Proposing Release insightfully points out, under the plain language of the existing loan provision, an auditor's independence could be impaired with respect to a fund audit client if it were not in compliance with the loan provision with respect to a fund within the ICC that is not the auditor's client.[58]

We agree with the Commission that the scope of the loan provision is too broad in this respect and support the proposed amendments that would exclude other funds in the ICC from the definition of "audit client" for purposes of the loan provision. However, we believe that the Commission should consider broadening this exclusion to include other companies within the ICC. In addition, we are recommending that the Commission consider revising the definition of "accounting firm" to exclude certain associates of the firm from the scope of the loan provision.

A. Invesco Recommends Excluding Other Companies within the ICC from the Scope of the Loan Provision

We urge the Commission to consider two alternative proposals to broaden the scope of the companies excluded from the definition of "audit client" for purposes of the loan provision when the audit client is part of an ICC as follows: (1) exclude companies within the same ICC from the definition of "audit client"; or (2) exclude investment advisers and any person controlled by an investment adviser from the definition of "audit client."

1. *Exclude all other companies within the ICC from the definition of "audit client" for purposes of the loan provision.*

As noted above, the definition of ICC broadly encompasses, among others, each company in the ICC of which the audit client is a part even though the threats posed to an auditor's independence with respect to those entities is remote when the impairment arises solely from a lending relationship. Investment advisers that are part of an ICC frequently engage the auditor to the funds within the ICC to audit its own financial statements and the financial statements of its affiliates, which include the adviser's holding company which may be required to file financial statements audited by an independent public accounting firm with the Commission under the Exchange Act.

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[55] In this context, we use the term "aware" with respect to an auditor and "materiality" as it relates to lending relationships as described in Sections II.G and III.D.2 of this letter.
[56] *See* Section II.G.
[57] The ICC may even include certain foreign investment companies that do not make a public offering of their securities in the U.S. For example, offshore funds governed under the European Union's *Undertakings for the Collective Investment of Transferable Securities* ("UCITS") could be considered investment companies but for the exclusion under Section 3(c) of the 1940 Act [15 U.S.C. § 80a-3(c)]. The ramifications of the impairment of an auditor's independence as a consequence of a UCIT fund coming within the scope of the ICC may be difficult to predict.
[58] *See* Proposing Release at note 65.

If an auditor were to violate the loan provision with respect to a fund within the ICC, its independence would be impaired with respect to all other entities within the ICC, including the fund's investment adviser and any company controlling or controlled by the investment adviser, including the adviser's parent company. However, we do not believe that the threats posed by lending relationships, which we have discussed herein in detail, would cause a reasonable investor with knowledge of all relevant facts and circumstances to believe that the auditor's objectivity might be impaired or subordinated with respect to other entities within the ICC.

We therefore strongly recommend that the Commission exclude not only funds from the definition of "audit client" for purposes of the loan provision but all companies that are part of the same ICC.

2. *Exclude investment advisers within the ICC and any company controlled by an adviser from the definition of "audit client" for purposes of the loan provision.*

In lieu of excluding all other companies within an ICC for purposes of the loan provision, we recommend excluding any investment adviser part of an ICC from the definition of "audit client" and any company controlled by an investment adviser within the same ICC.[59] We believe that this proposed exclusion is important for two reasons. First, an ICC may include multiple advisers that are part of the same ICC because they are sister companies of an investment adviser to a fund. These advisers may provide services that are totally unrelated to that of a fund adviser. For example, an adviser under common control with a fund adviser may limit its business to managing institutional separate accounts or the accounts of non-U.S. persons (including pooled investment vehicles). In addition, investment advisers within the same ICC may control subsidiaries such as broker-dealers that are required to file financial statements with the Commission under the Exchange Act that have been audited by an independent public accountant. These subsidiaries may not underwrite or distribute the securities of a fund but would nevertheless be affected by a violation of the loan provision because they are controlled by an adviser within the same ICC.

In addition, investment advisers that are part of an ICC of which an audit client is a part may conduct business that is unrelated to serving as the investment adviser to registered investment companies such as managing private funds, operating commodity pools, managing institutional separate accounts, providing model portfolio services or "robo" advice.[60] There may be many unintended or unforeseen consequences for such business lines if the entire ICC is tainted by a violation of the loan provision. For example, under the custody rule, advisers to private funds often depend upon certain exemptions thereunder that require the financial statements of a pooled investment vehicle to be audited by an independent accountant or in some cases may be required to have client assets verified by an independent accountant. If the auditor's independence is impaired as the result of the application of the loan provision to an unrelated registered investment company, the violation may also cause an inadvertent violation of the custody rule.[61]

B. Invesco Recommends Narrowing the Scope of "Accounting Firm" for Purposes of the Loan Provision

Regulation S-X defines the term "accounting firm" as "an organization . . . that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission . . . and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, *including those located outside of the United States*" (emphasis added).[62] We recommend narrowing the scope of the definition of "accounting firm" for purposes of the loan provision to exclude parts of the organization located outside of the United States that do not participate in an audit engagement. We believe the threats (if any) arising from a lending relationship between an accounting firm's foreign affiliates and lenders that have a beneficial interest in an audit client are extremely tenuous and would not have a bearing on the firm's independence in the absence of other facts and circumstances that might lead a reasonable investor with knowledge of such facts and circumstances to believe the auditor's independence may be impaired.

C. Invesco Recommends Narrowing the Lenders that are within the Scope of the Loan Provision

We recommend that the Commission confirm that certain lenders that are attenuated from the relationship between the auditor and its audit client will continue to be excluded from the scope of the loan provision as revised. Specifically, it has been noted that, under the existing loan provision, the relevant institutions are those that control the record or beneficial owner of more than 10 percent of the shares of an audit client (*i.e.*, companies that are under common control with or controlled by the record or beneficial owner are not implicated by the loan provision).[63] We do not believe that the amendments to the loan provision the Commission proposes intend to change those lenders implicated under the loan provision as it exists today.

* * * * *

We appreciate the opportunity to comment on the proposal. If you have any questions regarding our comments or would like additional information, please contact me at [redacted] or [redacted].

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[59] We present this alternative for consideration should the Commission decline to accept our proposal to exclude all other companies within the ICC from the definition of "audit client" for purposes of the loan provision.

[60] We note that the operation of certain commodity pools by an investment adviser that is part of an ICC would not be covered under the proposed exclusion since such companies may not invest in securities and are therefore outside the scope of the definition of an investment company and need not rely on Section 3(c) of the 1940 Act or the rules thereunder.

[61] We note that Rule 206(4)-2(d)(3) under the Investment Advisers Act of 1940, as amended, states that an accountant is independent if meets the standards described in Rule 2-01(b) and (c) of Regulation S-X. It is therefore ambiguous as to whether the auditor must be independent of the private fund, the adviser or both.

[62] *See* Rule 2-01(f)(2) of Regulation S-X [17 C.F.R. § 210.2-01(f)(2)].

[63] *See* Fidelity No-Action Letter (June 20, 2016) at note 5.

Sincerely,

/s/ Sheri L. Morris

Sheri L. Morris
President and Treasurer
Invesco Funds

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

Wesley Bricker, Chief Accountant
Office of Chief Accountant

Dalia O. Blass, Director
Alison Staloch, Chief Accountant
Division of Investment Management

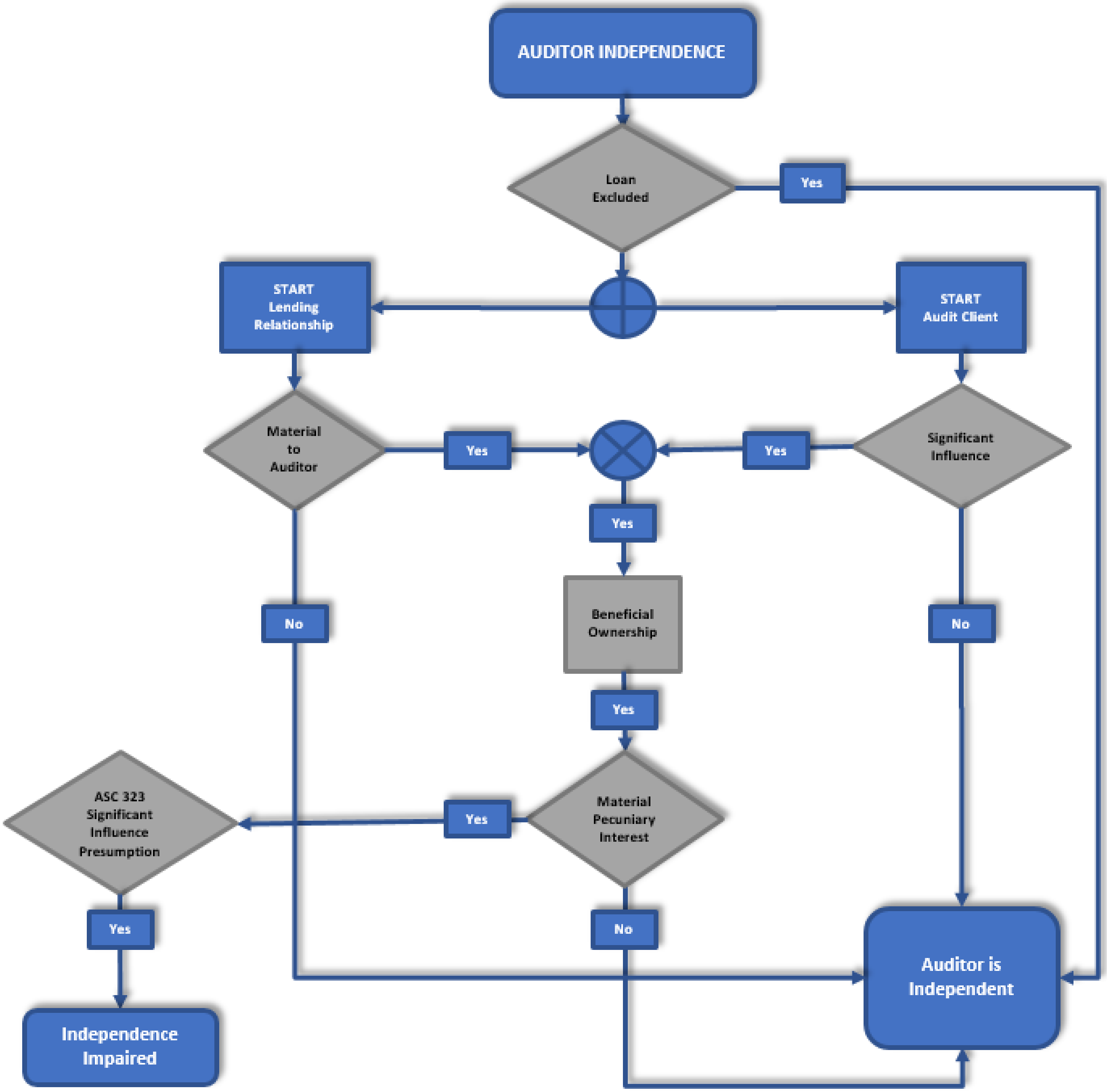
Appendix A: Proposed Revisions

Amend Section 210.2-01 by revising paragraph (c)(1)(ii)(A) to read as follows:

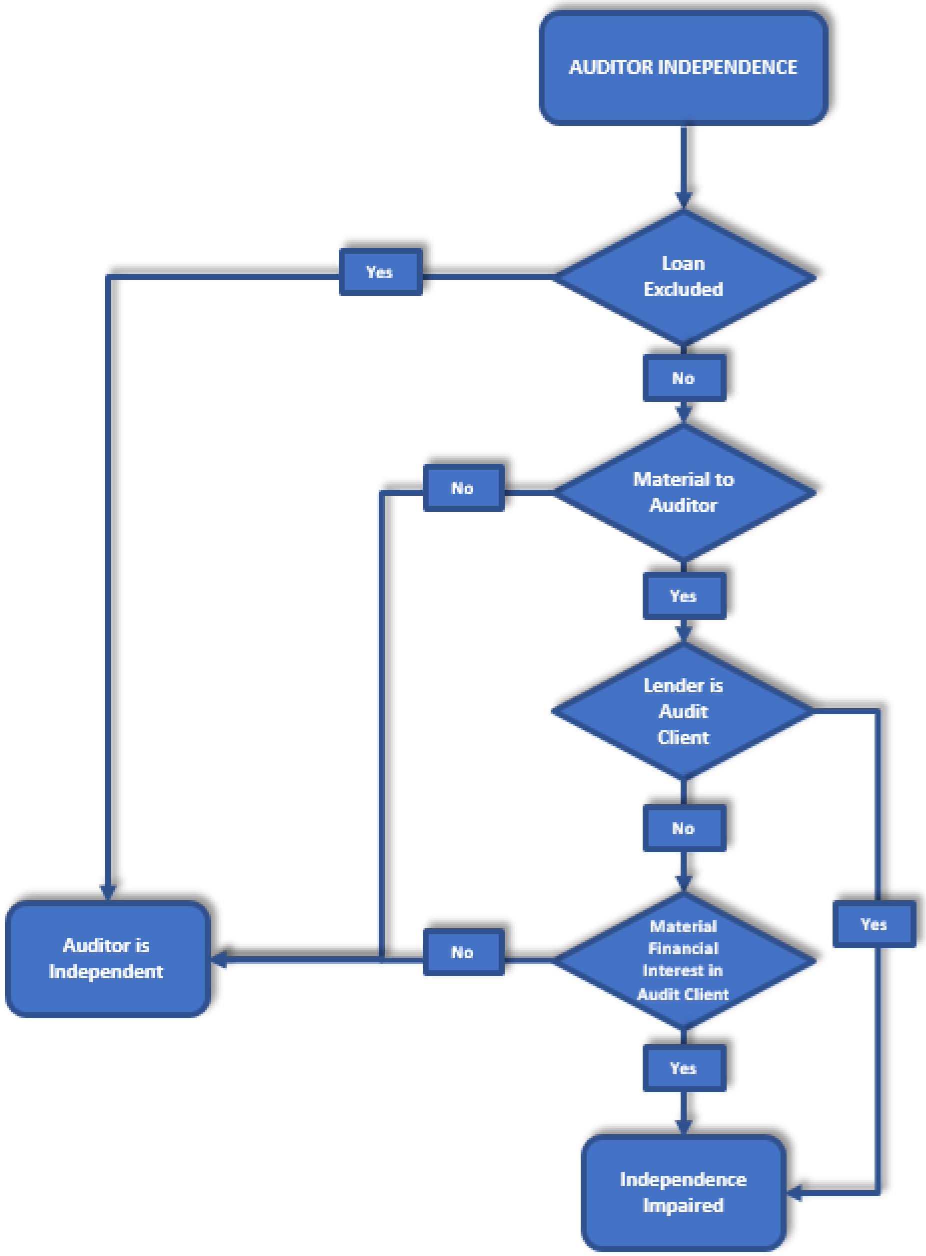
> (A) *Loans/debtor-creditor relationship*. Any loan (including any margin loan) to or from an audit client, or an audit client's officers, or directors~~, or record or beneficial owners of more than ten percent of the audit client's equity securities~~ or an entity that has a material direct financial interest in the audit client that is known to the auditor, unless the loan is not material to the accounting firm, any covered person in the firm, or any of his or her immediate family members, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:
>
> (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.

Note: For illustrative purposes only. The proposed revisions in this Appendix do not include our other recommendations discussed herein.

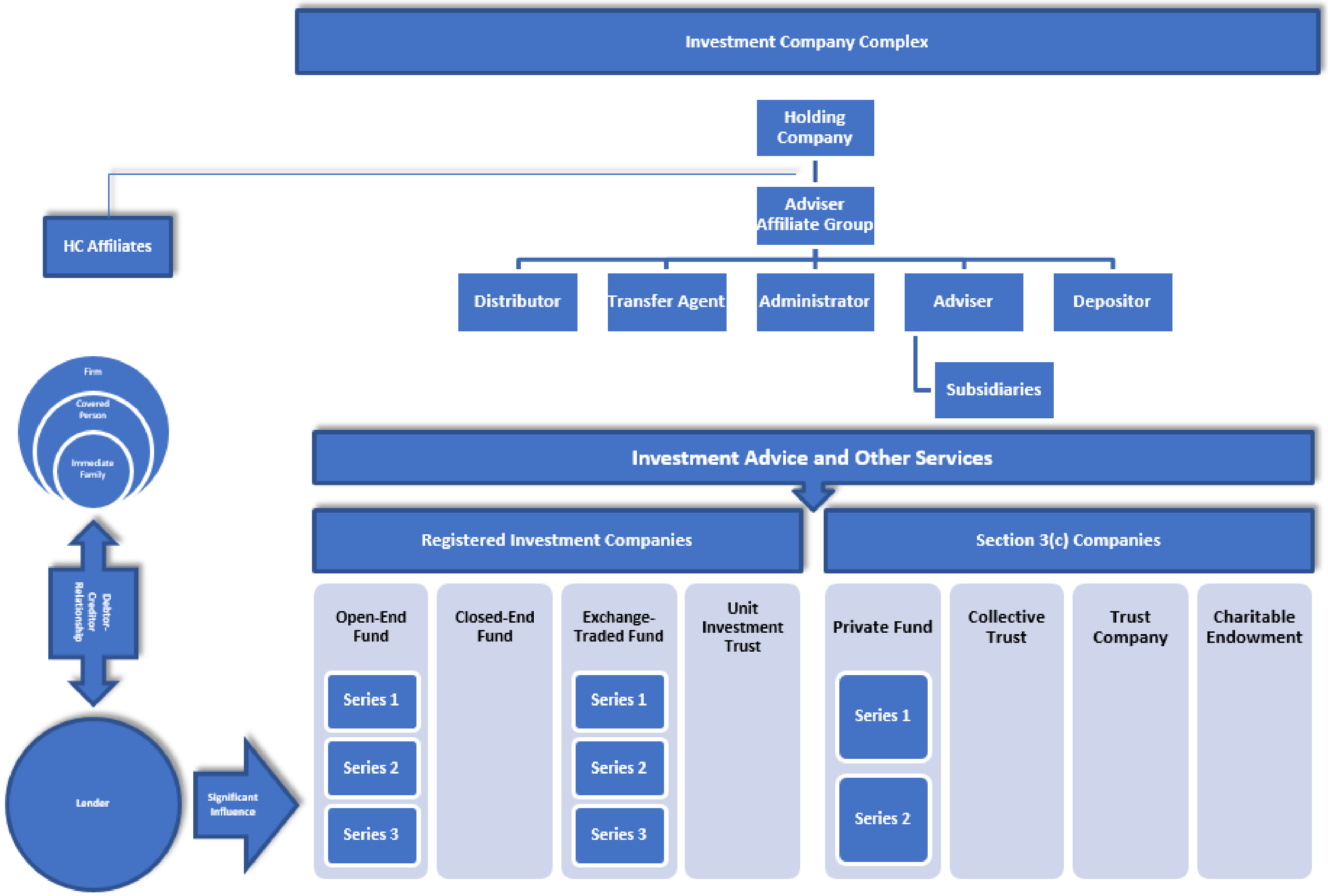
Appendix B: Decision Tree under Proposed Rule



Appendix C: Decision Tree under Proposed Alternative



Appendix D: Scope of Investment Company Complex



Note: If any company under the ICC is tainted by a violation of the loan provision, all companies within the ICC are also tainted. This graphic illustrates the far-reaching implications, which may be both unintended and unpredictable.

Appendix E:

Figures 1 and 2 on pages 8 and 9, respectively, are reproduced here to enhance their legibility.

Figure 1:

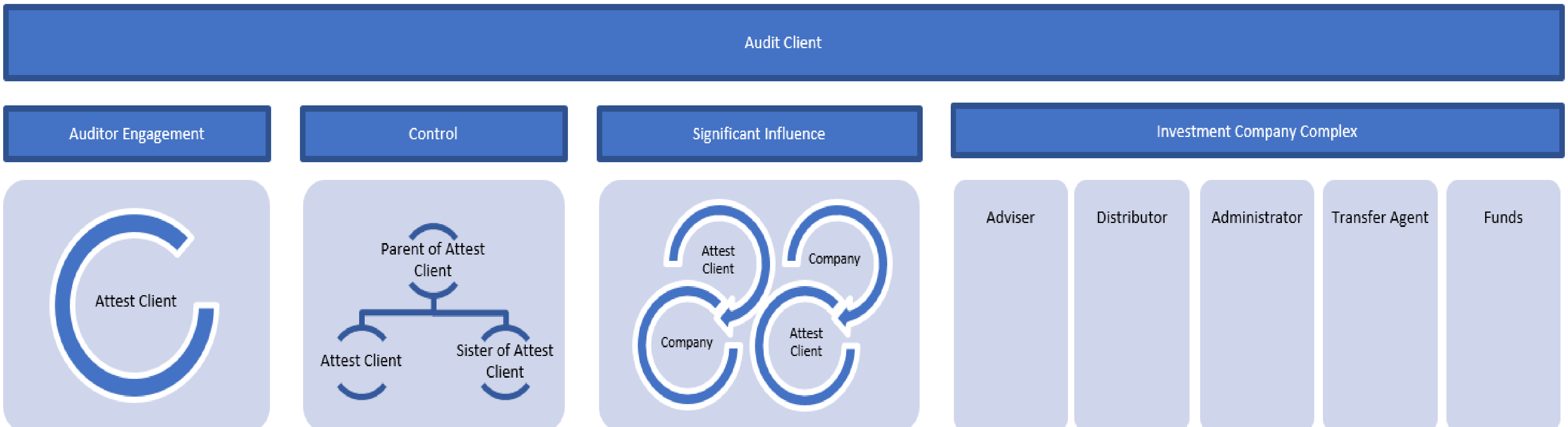
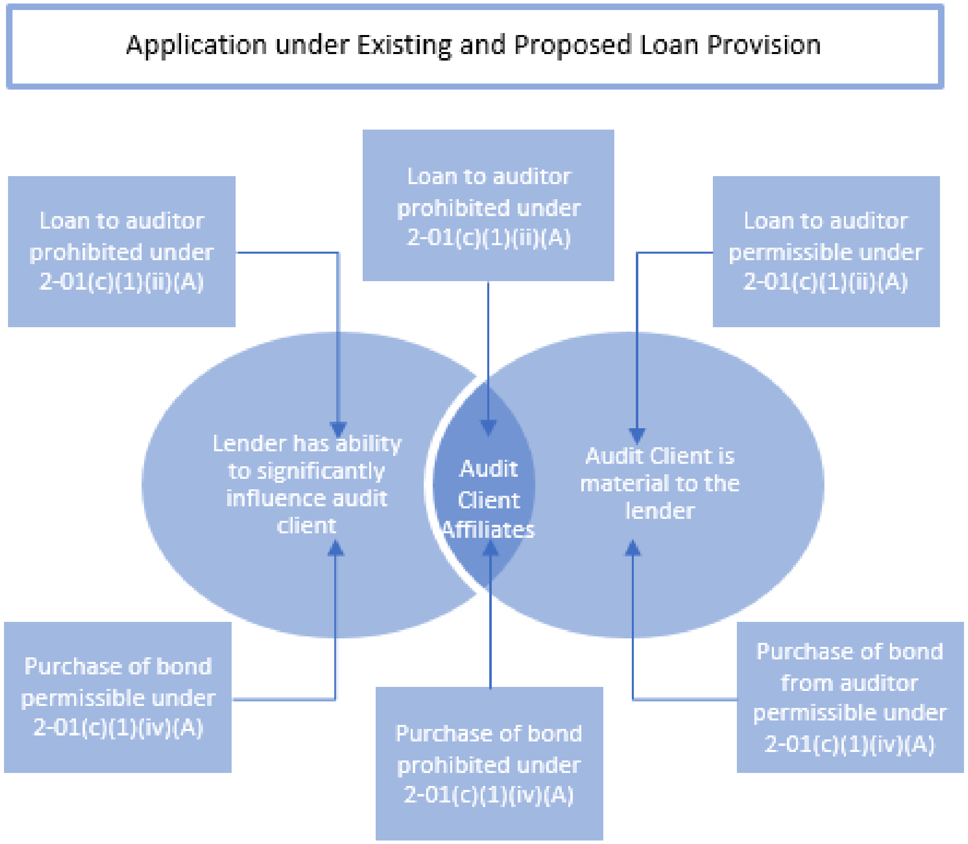


Figure 2:


Application under Existing and Proposed Loan Provision
Loan to auditor prohibited under 2-01(c)(1)(ii)(A)
Loan to auditor prohibited under 2-01(c)(1)(ii)(A)
Loan to auditor permissible under 2-01(c)(1)(ii)(A)
Lender has ability to significantly influence audit client
Audit Client Affiliates
Audit Client is material to the lender
Purchase of bond permissible under 2-01(c)(1)(iv)(A)
Purchase of bond prohibited under 2-01(c)(1)(iv)(A)
Purchase of bond from auditor permissible under 2-01(c)(1)(iv)(A)
Application under Proposed Alternative
Loan to auditor prohibited
Lender has ability to significantly influence audit client
Audit Client Affiliates
Audit client is material to lender
Lender has material direct financial interest
Purchase of bond prohibited under 2-01(c)(1)(iv)(A)

Appendix F: Examples of Proposed Alternative

In this Appendix, we present examples of how our proposed alternative to the loan provision may work in practice. Our examples are not exhaustive; however, we hope the Commission will find them useful in assessing the merits of our alternative.

1. *The auditor becomes aware that a material lender has a financial interest in an audit client.*

In the course of reviewing a lender's publicly available financial statements, an auditor becomes aware that a significant portion of the lender's current assets are concentrated in its audit client. The auditor assesses whether its lending arrangements with the lender are material to the firm, any covered persons and their immediate family members. The auditor concludes that the lending relationship is material for among other reasons because the lender provides a large committed unsecured credit facility that the firm frequently draws down for temporary working capital due to the lender's favorable discretionary bid rate. In addition, the auditor determines that many new partners rely on the lender to finance their "buy-in" and that the lender has extended a personal loan to an immediate family member of a covered person that is material to that individual's net worth.

Upon further review, the auditor concludes the lender cannot exercise significant influence over the audit client in part because the lender invests in the audit client's bonds. In the course of auditing its client's financial statements, the auditor learns of facts that must be disclosed in the audit client's financial statements. The disclosure of these facts will likely cause the audit client's bond to be downgraded with corresponding decreases in the market value of the bonds and their liquidity.

The auditor is not independent of the audit client because the auditor has a material lending relationship with a lender that has a material direct financial interest in the audit client. Under such circumstances, the auditor may subordinate its objectivity and issue a favorable opinion on its client's financial statements to prevent the diminution of its lender's investment in the audit client either for the purpose of currying favor with the lender or to prevent the lender's financial condition from being impaired such that it is no longer able to lend on favorable terms.

2. *The auditor becomes aware that a non-material lender has a financial interest in an audit client.*

In the course of reviewing a client's financial statements, the auditor learns that a lender has entered into a bilateral swap agreement with its audit client. The swap agreement does not confer any voting or other rights to the lender that would enable the lender to exercise significant influence over the audit client. However, under the terms of the swap agreement, a party is required to post collateral to secure its obligations under the swap agreement only if one party's obligation to the other exceeds a certain threshold. If the audit client defaults under the swap agreement, the auditor's lender stands to recognize a significant loss.

Upon further review, the auditor concludes that, although the lender could absorb the loss in the event of a default by its client due to the lender's size and strength, the swap represents a material financial interest in the audit client due to the amount at risk should the audit client default. Since the lender has a direct material financial interest in the audit client, the auditor's independence could be impaired.

The auditor assesses its balances with the lender and finds that the lender is part of a syndicate of banks that have extended a capital loan to the firm. The loan has a fixed rate of interest and a term of 15 years and cannot be called in the absence of a default. For this and other reasons the auditor concludes that the lending relationship is not material, and accordingly, its independence is not impaired.