



August 7, 2023

By email: [comments@pcaobus.org](mailto:comments@pcaobus.org)

Ms. Phoebe W. Brown  
Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

Re: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations; PCAOB Rulemaking Docket Matter No. 051

Dear Ms. Brown:

The Investment Company Institute<sup>1</sup> and the Independent Directors Council<sup>2</sup> appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed amendments to auditing standards related to a company's noncompliance with laws and regulations.<sup>3</sup> The Proposed Amendments aim to establish new, and strengthen existing, auditor requirements for identifying and

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<sup>1</sup> The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. ICI's members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in other jurisdictions. Its members manage \$31.2 trillion invested in funds registered under the US Investment Company Act of 1940, serving more than 100 million investors. Members manage an additional \$8.7 trillion in regulated fund assets managed outside the United States. ICI also represents its members in their capacity as investment advisers to certain collective investment trusts (CITs) and retail separately managed accounts (SMAs). ICI has offices in Washington DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

<sup>2</sup> The [Independent Directors Council](#) (IDC) serves the US-registered fund independent director community by advancing the education, communication, and public policy priorities of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of ICI member funds. There are approximately 1,600 independent directors of ICI-member funds.

<sup>3</sup> See Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments, PCAOB Release No. 2023-003 (June 6, 2023)(the Proposed Amendments), *available at* [https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf?sfvrsn=fc43e8a\\_2](https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf?sfvrsn=fc43e8a_2).

assessing noncompliance with laws and regulations, evaluating information indicating potential noncompliance, and communicating findings to relevant parties. We support having robust auditing standards as a general matter. Audits of registered investment companies and business development companies ((BDCs), and together with registered investment companies, (Funds)), however, should be excluded from the Proposed Amendments, given their unique business and legal structure and the well-established robust regulatory regime under which they operate.

We appreciate the PCAOB's stated goals, but we agree with others that the Proposed Amendments "could dramatically increase the scope and cost of audits for highly regulated institutions while simultaneously disregarding the existing supervisory and examination frameworks that already assess compliance with laws and regulations."<sup>4</sup> Focusing an auditor's attention on legal matters not clearly related to financial statements could threaten audit quality and force auditors to engage in legal and compliance matters with which lawyers, management, and regulatory and law enforcement authorities already are tasked. Requiring auditors to perform duplicative and unnecessary work would drive up auditor costs significantly.

These concerns are particularly true for Funds. Funds are distinct from operating companies because virtually all their management and operations are outsourced to third parties. In addition, unlike operating companies, a Fund's assets consist almost entirely of investments.<sup>5</sup> This structure gives rise to straightforward, less complex, and more standardized financial reporting and corresponding audits as compared to those of operating companies.

In addition, Funds are subject to unparalleled layers of stringent requirements that govern all their activities and oversight by others to ensure compliance with those requirements. For example, every Fund must have a chief compliance officer (CCO) and is overseen by a board of directors. The Investment Company Act of 1940 requires that at least 40% of each fund's board be independent, and, in practice, a majority of funds go further with independent directors making up 75% of their boards.<sup>6</sup> The Proposed Amendments therefore are unnecessary to protect fund shareholders.

Recognizing Funds' unique structure and the comprehensive legal framework to which they are subject, the PCAOB previously sought specific feedback on whether it should treat Funds differently from

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<sup>4</sup> See Letter from American Bankers Association, ACA International, *et al.* to Ms. Phoebe W. Brown, Secretary, PCAOB, dated Aug. 7, 2023 (providing comments on the Proposed Amendments from several U.S. trade associations, including ICI).

<sup>5</sup> A Fund's primary purpose is to "mutually" invest and reinvest pooled capital from multiple investors in securities of other companies.

<sup>6</sup> See Independent Directors Council, *Overview of Fund Governance Practices, 1994-2020* (Oct. 2021)(Overview) at 5, available at [https://www.idc.org/system/files/2021-10/21\\_pub\\_fund\\_governance.pdf](https://www.idc.org/system/files/2021-10/21_pub_fund_governance.pdf).

operating companies for purposes of rulemaking,<sup>7</sup> and it has done so on several occasions.<sup>8</sup> The PCAOB should act similarly in this case for the following reasons:

- Funds have unique structures that differ significantly from that of operating companies.
- Funds already are subject to a robust regulatory framework within which their investment adviser, CCO, and board of directors all have both specific and general responsibilities, including under a dedicated and well-established compliance program rule.
- Funds are subject to stringent SEC disclosure and reporting requirements, as well as SEC inspections and examinations.
- The Proposed Amendments do not include any economic analysis of the impact on Funds and their shareholders, which is essential to any standard setting that impacts Funds.

1. Funds Have Unique Structures.

The Proposed Amendments would significantly increase an auditor's obligations to identify, evaluate, and communicate noncompliance by, among other things, mandating that the auditor employ procedures designed to detect *any* noncompliance that could have an *indirect* effect on financial statements.<sup>9</sup> The Proposed Amendments are clearly intended to cover operating companies but are drafted in a manner that extends their application to Funds. As explained above and in more detail below, Funds are uniquely structured, exist primarily to deploy investor capital, and are subject to a robust regulatory framework. We therefore strongly recommend that the PCAOB exclude Funds from the scope of the Proposed Amendments. Funds are fundamentally different than operating companies for the reasons set forth below:

- *Disclosure Updates:* The investment objective and investment strategy for a Fund is described and stated clearly in the Fund's prospectus, which is typically updated annually and keeps investors

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<sup>7</sup> See, e.g., PCAOB, *Discussion – Audit Quality Indicators* (Nov. 14, 2014) at 6, Question 14, available at [https://pcaobus.org/Information/Documents/11142013\\_AQI\\_Discussion.pdf](https://pcaobus.org/Information/Documents/11142013_AQI_Discussion.pdf).

<sup>8</sup> See, e.g., The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards, PCAOB Release No. 2017-001 (June 1, 2017) at 106 (excluding investment companies other than BDCs from requirements relating to communications of critical audit matters), available at <https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf> and Establishment of Accounting Support Fee, PCAOB Release No. 2003-003 (Apr. 18, 2003) at A2-vi (recognizing the relatively less complex nature of investment company audits in assessing them accounting support fees at ten percent of the amount operating companies pay) available at [https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket\\_002/2003-04-18\\_release\\_2003-003.pdf?sfvrsn=f1030cd7\\_0](https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket_002/2003-04-18_release_2003-003.pdf?sfvrsn=f1030cd7_0).

<sup>9</sup> Currently, Auditing Standard 2405 (AS 2405), in conjunction with the illegal acts provisions of Section 10A of the Securities Exchange Act of 1934, does not mandate audit procedures designed to detect illegal acts with an *indirect* effect on financial statements. The PCAOB contends that the Proposed Amendments may prevent instances where financial statements are materially misstated due to legal and regulatory noncompliance.

informed of changes. This is in contrast to disclosure requirements for public operating companies, which typically engage in a multitude of activities and services that can change over time without making corresponding changes to their registration statements.

- *Operational Simplicity:* The purpose of a Fund is to pool capital from multiple investors and invest it in a diversified portfolio of securities. The vast majority of Funds are externally managed and generally do not have employees. Instead, Funds rely on third-party service providers (*e.g.*, the investment adviser, distributor, custodian, transfer agent, and others) to invest fund assets and carry out other business activities. Funds typically do not engage in complex operations or the production of goods, materials, or services and, therefore, do not contend with the complexities associated with manufacturing, supply chains, or other common issues that operating companies face.
- *Financial Structure:* Funds have a relatively straightforward financial structure. They issue shares to investors, and the value of these shares is directly linked to the net asset value (NAV) of a Fund's assets. The NAV represents the total fair value of the Fund's assets minus its liabilities, divided by the number of outstanding shares. Public operating companies, on the other hand, have multifaceted financial structures, including complex balance sheets, revenue recognition and consolidation concerns, and potential capitalization intricacies such as options, restricted units, warrants, or combinations of convertible debt, preferred and common stock comprising their equity.
- *Regulatory Framework:* As further described below, Funds have long been subject to specific regulations under the Investment Company Act, which provide a robust and well-defined legal framework for their management and operations.<sup>10</sup> An additional overlay, such as that in the Proposed Amendments, would be unnecessarily duplicative and costly to Funds and their shareholders.
- *Governance:* As noted above, every Fund is required by law to have a board of directors with a certain percentage of independent directors. In practice, independent directors make up three-quarters of the board for most Funds. According to the Supreme Court, Fund independent directors have “the primary responsibility” for looking after the interests of the fund's shareholders and serve as “independent watchdogs” who “furnish an independent check” upon the management of the Fund.<sup>11</sup> This intense and dedicated focus on protecting the interests of the Fund and its shareholders differs from that of public operating company boards, which may weigh in on such

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<sup>10</sup> Each type of Fund is an “investment company” subject to the Investment Company Act. The Investment Company Act generally defines an “investment company” as any issuer that is engaged primarily in the business of investing, reinvesting, owning, holding, or trading in securities. *See* Section 3(a)(1) of the Investment Company Act.

<sup>11</sup> *See Burks v. Lasker*, 441 U.S. 471, 484-85 (1979).

matters as a company's strategic planning and its executive compensation. In addition, the Investment Company Act and its rules set forth specific Fund board duties, including the hiring of the independent auditor.

- *Financial Reporting:* Funds are subject to more standardized and transparent financial reporting processes than those of public operating companies. Funds are required to regularly make regulatory filings, which include disclosures about portfolio holdings, thereby providing more transparency to investors and regulators.
  - *Audit Scope.* Given Funds' unique structure and their singular purpose, external auditors already comprehensively test the most material part of a Fund's balance sheet—its investments—with 100 percent testing for existence and valuation. This differs from operating companies for which auditors rely more heavily on a sampling-based methodology to test material financial statement balances.
2. Funds Already Are Subject to a Robust Regulatory Framework Within Which Their Investment Adviser, CCO, and Board of Directors All Have Both Specific and General Responsibilities.

In addition to adhering to the securities laws to which public companies are subject, Funds must comply with a unique regulatory framework under the Investment Company Act. A Fund's compliance with this framework is overseen by the Fund's CCO and its board of directors, and Funds are subject to periodic inspections from the staff of the SEC's Division of Examinations.<sup>12</sup> This comprehensive regulatory regime seeks to ensure that Funds and their service providers comply with the federal securities laws and operate for the benefit of shareholders. It also significantly mitigates the risk of noncompliance with laws and regulations as they relate to investments, which are virtually the entirety of a Fund's assets.

For example, the Investment Company Act includes specific requirements for Funds with respect to portfolio diversification, liquidity, and leverage.<sup>13</sup> Moreover, every Fund is bound by statutory valuation requirements. In addition to the requirement that an auditor completely and comprehensively test Fund investments for existence and valuation, a Fund must value its portfolio holdings daily.<sup>14</sup> The SEC recently strengthened this framework by requiring Funds to assess and manage material risks associated with fair

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<sup>12</sup> Moreover, many Fund service providers (*e.g.*, Fund investment advisers, custodians, and transfer agents) are subject to their own regulatory requirements.

<sup>13</sup> *See, e.g.*, Sections 5, 13, 22, and 18 of the Investment Company Act.

<sup>14</sup> A Fund must value its holdings using the market value when market quotations are "readily available," and using the investment's fair value as determined in good faith by the Fund's board, when a market quotation for a portfolio security is not readily available or if the investment is not a security. *See* Section 2(a)(41) of the Investment Company Act. *See also* Rule 2a-4 under the Investment Company Act.

value determinations; select, apply, and test fair value methodologies; and oversee and evaluate any pricing services used. Fund boards are empowered to designate a "valuation designee" to perform fair value determinations.<sup>15</sup> In addition to these valuation requirements, Funds must custody their assets with a qualified third-party custodian.<sup>16</sup>

In addition, Fund advisers, CCOs, and Fund boards have both general and specific duties and responsibilities to support a Fund's compliance with its statutory and regulatory obligations. Under the Investment Advisers Act of 1940, each investment adviser to a Fund owes the Fund—its client—fiduciary duties to act with a duty of care and a duty of loyalty and the investment adviser is subject to statutory antifraud liability.<sup>17</sup> The SEC has described the combination of care and loyalty obligations as "requiring the investment adviser to act in the 'best interest' of its client [the Fund] at all times" and, in adhering to these duties, an investment adviser cannot waive its fiduciary obligations or its obligations under the Investment Advisers Act.<sup>18</sup>

The Investment Company Act and the Investment Advisers Act also set forth specific rules designed to prevent violations of the federal securities laws. For example, Rule 38a-1 under the Investment Company Act requires Funds to adopt and implement internal compliance programs reasonably designed to prevent violations of the federal securities laws, including under the Investment Company Act, Investment Advisers Act, Securities Act of 1933, Securities Exchange Act, and the regulations thereunder.

Rule 38a-1 requires each Fund to appoint a CCO responsible for administering these Fund policies and procedures. The rule also assigns specific responsibilities to the Fund board, including that the Fund board approve the designation, compensation, and removal of the Fund CCO. In addition, the Fund CCO is tasked with overseeing various Fund service providers, including the investment adviser, principal underwriter, administrator, and transfer agent (*i.e.*, they essentially are required already to have a compliance audit). These entities are within the scope of the CCO's annual review and testing and related board reporting requirements. This compliance structure is unique to Funds, as public operating companies are not required to implement such a rigorous compliance oversight framework.

Similarly, Rule 206(4)-7 under the Investment Advisers Act requires a Fund's investment adviser to adopt and implement written policies and procedures which are reasonably designed to prevent the violation of the Investment Advisers Act and its rules, and to designate a CCO who is responsible for administering

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<sup>15</sup> If a board designates the determinations of fair value to a valuation designee for any of the Fund's investments under Rule 2a-5, Rule 2a-5 requires the board to oversee the valuation designee's performance of fair value determinations.

<sup>16</sup> See Section 17(f) under the Investment Company Act.

<sup>17</sup> *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Investment advisers also have antifraud liability with respect to prospective clients under Section 206 of the Investment Advisers Act.

<sup>18</sup> See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Inv. Advisers Act Rel. No. 5248 at 7-8; 10-11, available at <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>.

the investment adviser's compliance policies and procedures. Collectively, the requirements applicable to investment advisers under the Investment Advisers Act and to Funds under the Investment Company Act are designed to ensure strict oversight and prevention of abuses to Funds and their shareholders.

Further, the Investment Company Act tasks Fund boards with a unique role to provide independent oversight for the benefit of Fund shareholders.<sup>19</sup> As noted above, the Investment Company Act mandates a certain percentage of a Fund's board be independent.<sup>20</sup> In practice, independent directors make up three-quarters of Fund boards for most Funds and more than two-thirds of Funds have an independent chair.<sup>21</sup> Investment Company Act rules also establish governance standards for Fund boards that nearly all must follow.<sup>22</sup> For example, Fund independent directors must select and nominate other independent directors; an attorney for the Fund's independent directors must meet the definition of "independent legal counsel;" Fund boards must conduct annual self-assessments designed to increase their effectiveness; and the independent directors must meet in executive session at least quarterly.

Fund directors also have significant and specific responsibilities under the federal securities laws. Among other things, they oversee the Fund's operations, including investment management, compliance with regulations, and financial reporting. The Investment Company Act imposes specific responsibilities on Fund boards to ensure they monitor potential conflicts of interest between the Fund and its adviser. Board oversight provides an additional layer of shareholder protection and helps to promote transparency, accountability, and investor confidence.

### 3. Funds Are Subject to SEC Disclosure and Reporting Requirements, and Inspections and Examinations by SEC Staff.

The Proposed Amendments would extend the scope of an audit to detect noncompliance with all applicable laws and regulations.<sup>23</sup> Given that the SEC already strictly regulates funds, this additional layer of oversight would be duplicative and unnecessary.

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<sup>19</sup> Like public operating companies, Fund boards have a fiduciary duty to represent the interests of shareholders.

<sup>20</sup> At least 40% of a Fund's board members cannot be "interested persons" of the Fund, *i.e.*, they must be "independent" directors (and, in many cases, at least a majority of the board members must be independent). The Investment Company Act defines "interested person" broadly and, consequently, establishes a strict threshold for director independence. *See* Section 2(a)(19) of the Investment Company Act.

<sup>21</sup> *See* Overview, *supra* n. 6, at 5, 10.

<sup>22</sup> *See* Inv. Co. Act Rel. No. 24816 (Jan. 2, 2001) (adopting rule amendments focused on Fund board governance requirements of independent directors for Funds relying on certain exemptive rules). Nearly every Fund relies on at least one of the exemptive rules and is therefore subject to the requirements.

<sup>23</sup> We question whether auditors have the skills and expertise to evaluate the legal and compliance matters.

The Investment Company Act extends far beyond the disclosure and antifraud requirements characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on Funds to ensure their effectiveness in disclosure and reporting, and to prevent and/or detect Fund violations and mitigate Fund-specific risks. Various rules (*e.g.*, the liquidity rule, the derivatives rule, etc.) require direct reporting to the SEC either periodically (on SEC forms, such as N-PORT or N-CEN) or under certain conditions (on SEC forms, such as N-RN), all of which is unique to Funds.<sup>24</sup> Other Fund documents and materials outside of periodic and current reports, such as Fund prospectuses and marketing materials, must comply with their own regulations under various SEC and FINRA rules, and are subject to SEC or FINRA review. Additionally, they are covered by the CCO's annual compliance review.

Funds and their investment advisers are subject to periodic on-site SEC inspections, which are designed to detect noncompliance with laws and regulations, including fraud. These inspections typically include a review of Funds' audited financial statements. Equivalent SEC on-site inspections do not exist for public operating companies. This unique level of regulatory scrutiny imposed on Funds provides an additional layer of compliance testing and assurance to ensure Funds take their legal and regulatory compliance obligations seriously.<sup>25</sup>

#### 4. The Proposed Amendments Do Not Consider the Economic Impact That Funds and Their Shareholders Would Bear.

The PCAOB did not evaluate the economic impact of the Proposed Amendments on Funds and their shareholders. As the PCAOB has stated, in standard setting it should "follow an evidence-based approach, which includes economic analysis. This approach is responsive to the financial reporting and auditing environments, carefully weighs costs, benefits, and potential unintended consequences, and contemplates our mission to protect investors."<sup>26</sup>

The Proposed Amendments would be costly for Funds with no corresponding benefits. Requiring an auditor to identify all rules and regulations to which a Fund may be subject would significantly and unnecessarily expand the scope of a Fund audit (*e.g.*, by requiring a detailed review of its compliance programs, registration statements, and marketing information, etc.). Auditors would need to acquire a

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<sup>24</sup> See, generally, Investment Company Reporting Modernization (Oct. 13, 2016), Inv. Co. Act Rel. No. 32314, *available at* <https://www.sec.gov/files/rules/final/2016/33-10231.pdf>.

<sup>25</sup> To ensure that Funds address common compliance issues or concerns that the SEC staff believes present potential risks to investors and to the integrity of the U.S. capital markets, the SEC's Division of Examinations issues annual exam priorities that serve as a *de facto* requirement for Funds to review and strengthen their compliance obligations in certain areas. See, *e.g.*, SEC Division of Examinations, 2023 Examination Priorities, *available at* <https://www.sec.gov/files/2023-exam-priorities.pdf>.

<sup>26</sup> See PCAOB, "Spotlight: The PCAOB's Use of Economic Analysis and Stakeholder Input in Standard Setting" (Nov. 2020) at 2, *available at* [https://assets.pcaobus.org/pcaob-dev/docs/default-source/documents/pcaob-use-economic-analysis-stakeholder-spotlight.pdf?sfvrsn=9cb7e4d0\\_2](https://assets.pcaobus.org/pcaob-dev/docs/default-source/documents/pcaob-use-economic-analysis-stakeholder-spotlight.pdf?sfvrsn=9cb7e4d0_2).



substantial amount of additional understanding and “audit evidence” from the Fund’s service providers to undertake such an audit. These costs likely would be borne by Fund shareholders.<sup>27</sup>

As noted above, expanding auditor responsibilities in the manner contemplated by the Proposed Amendments likely would lead to costly Fund audits that are duplicative of services already performed by certain Fund service providers, including the Fund’s investment adviser and outside legal counsel, among others, and are beyond the scope of an auditor’s skills and expertise. In addition, audit firms would incur both initial startup and additional ongoing costs associated with documenting their analyses and reporting to management, Fund audit committees, and Fund boards. Fund auditors would likely pass the costs for this increased workload to Fund shareholders, reducing shareholder returns without providing offsetting benefits.

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ICI and IDC have long supported sensible regulation that aims to protect Fund shareholders and help them make informed investment decisions.<sup>28</sup> But we cannot support the Proposed Amendments as they apply to Funds. They are overly broad, duplicative, and would lead to significant unintended impacts, including substantially increased costs for Fund shareholders. Given Funds’ unique structure, the robust regulatory framework under which they operate, and these corresponding costs, we urge the PCAOB to exclude Funds from the Proposed Amendments.

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<sup>27</sup> The proposed definition of “noncompliance with laws and regulations” expressly provides that such noncompliance by a company includes all violations of laws or regulations by the company whose financial statements are under audit, or by the company’s management, its employees, or *others that act in a company capacity or on the company’s behalf* (emphasis added). Release at 24. This broad definition raises several interpretive questions. It is not clear to us whether the reach of the Proposed Amendments would extend to a Fund’s service providers, such as its investment adviser, custodian, and transfer agent. We note many of these service providers are banks, subject to their own specific and highly specialized regulatory regime.

<sup>28</sup> See e.g. Letter from Karrie McMillan, ICI General Counsel, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, re Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies; File No. S7-28-07 (Feb. 15, 2008); and Letter from Craig S. Tyle, ICI General Counsel, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, re Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies; File No. S7-51-02 (Feb. 14, 2003); Letter from Dorothy A. Berry, IDC Governing Council Chair, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, re Comment Request for Study Regarding Financial Literacy Among Investors; File No. 4-645 (Mar. 23, 2012); Letter from Robert W. Uek to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, re Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies; File No. S7-28-07 (Feb. 15, 2008).

Ms. Phoebe W. Brown

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If you have any questions, please contact the undersigned, Jason Nagler, at (202) 961-5506 or [jason.nagler@ici.org](mailto:jason.nagler@ici.org) or Lisa Hamman, at (202) 371-5405 or [lhamman@ici.org](mailto:lhamman@ici.org).



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