UMB Fund Services

Industry Trends – August 2019

Industry Statistics – Mutual Funds

Fund Category	Net Assets (in billions) June-19	Net Assets (in billions) March-19	Percentage Change in Net Assets	Dollar Change in Net Assets (in billions) Total Change	Change Due to Net Cash Flows	Change Due to Market
Stock	$10,715.6	$10,418.0	2.9%	$297.6	($88.5)	$386.1
Hybrid	$1,513.0	$1,487.2	1.7%	$25.8	($14.7)	$40.5
Taxable Bond	$3,686.0	$3,550.3	3.8%	$135.7	$42.7	$93.0
Municipal Bond	$753.9	$719.4	4.8%	$34.5	$20.4	$14.1
Money Market	$3,201.5	$3,079.3	4.0%	$122.2	$111.3	$10.9
Total	$19,870.0	$19,254.2	3.2%	$615.8	$71.2	$544.6

- **Stock** fund assets increased during the quarter by $297.6 billion. For the quarter ended June 30, 2019, market appreciation was $386.1 billion compared to appreciation of $1,221.3 billion for the quarter ending March 31, 2019. The net assets for stock funds increased from $10,418.0 billion as of March 31, 2019 to $10,715.6 billion at the end of June 2019.

- **Hybrid** fund assets increased from $1,487.2 billion as of March 31, 2019 to $1,513.0 billion as of June 30, 2019. This compares to an increase of $104.4 billion in the first quarter of 2019. The increase was the result of market appreciation of $40.5 billion and net outflows of $14.7 billion.

- **Bond** funds had net inflows of $63.1 billion for the quarter ended June 2019, compared to the previous quarter inflows of $79.2 billion. Assets for all bond funds increased $170.2 billion for the quarter ended June 30, 2019 which included, market appreciation of $107.1 billion.

- **Money Market** funds had net inflows of $111.3 billion for the three months ended June 30, 2019, compared to the previous quarter inflows of $30.8 billion. Money market fund net assets, over for the three-month period, increased from $3,079.3 billion as of March 31, 2019 to $3,201.5 billion as of June 30, 2019.

Source: Investment Company Institute website

REGULATORY UPDATE

SEC Adopts Amendments to Auditor Independence Rule

The SEC recently adopted amendments to the "loan provision" of the auditor independence rules, which governs when an auditor is independent if it has a lending relationship with certain shareholders of an audit client. The SEC amended the provision after realizing that there are certain scenarios that do not impair an auditor's impartiality or objectivity despite a technical failure to comply with the provision. The amendments take effect on October 3, 2019. Specifically, the amendments:

- Focus the analysis on beneficial ownership, rather than both beneficial ownership and record ownership;
- Replace the existing 10 percent bright line ownership test with a "significant influence" test;
- Add a "known through reasonable inquiry standard" to identify beneficial owners of the audit client's equity securities; and
- Exclude from the definition of "audit client" for a fund under audit, any other funds (including registered funds, private funds, foreign funds, and commodity pools).

Senior Safe Act Becomes Law

The Senior Safe Act was included in the banking reform package that President Trump signed in May 2018.

"In recognition of the one-year anniversary of the passage of The Senior Safe Act, the North American Securities Administrators Association ("NASAA"), the U.S. Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") have issued a fact sheet to help raise awareness among broker-dealers, investment advisers, and transfer agents of the Act and how the Act's immunity provisions work."

The fact sheet includes a definition of what is covered under the Act, which types of employees must be trained to receive the immunity provided by the Senior Safe Act, the training requirements under the Senior Safe Act including when employees must be trained, the training records that must be maintained, how the requirements for "individual immunity" and "institutional immunity" differ, and whether immunity provided by the Senior Safe Act allows for contacting third parties. The fact sheet may be found at the following link.
https://www.finra.org/sites/default/files/senior_safe_act_factsheet.pdf

SEC Issues Final Rule Establishing Standards of Conduct for Broker-Dealers and Interpretation of the Fiduciary Duty of Investment Advisers

On June 5, 2019 the SEC adopted rules and interpretations "to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." Key to the rules and interpretations are:

(1) a new rule under the Exchange Act establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer ("broker-dealers") when making a recommendation to a "retail customer" ("Regulation Best Interest").

Regulation BI establishes a new standard of conduct that requires broker-dealers to act in the "best interests" of their "retail clients" when recommending securities and investment strategies. The best interest standard is intended to enhance current duties of suitability and fair dealing that historically have applied to a broker-dealer's business. Regulation BI imposes four obligations on broker-dealers in their recommendations of securities and investment strategies to retail customers. Those obligations include:

- *Disclosure.* A broker-dealer will be required to disclose the material facts about the relationship and recommendations, including information as to fees, conflicts, the broker-dealer's capacity in providing services, and, to the extent formally agreed upon, account monitoring.
- *Care.* A broker-dealer will be required to exercise reasonable diligence, care, and skill when making a recommendation.
- *Conflicts.* A broker-dealer will be required to implement written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate conflicts of interest.
- *Compliance Policies and Procedures.* A broker-dealer will be required to implement written policies and procedures reasonably designed to ensure compliance with Regulation BI as a whole.

(2) an interpretation regarding the standard of conduct for investment advisers under the Advisers Act ("Fiduciary Duty Interpretation").

The SEC's proposals included a proposed interpretation of the fiduciary standards that apply to advisers under the Advisers Act. The final version approved by the SEC is generally consistent with the proposal from April of 2018. The final version also includes provisions that summarize the SEC's views regarding an adviser's services to institutional clients.

Thus, the IA Interpretation reaffirms that an investment adviser has a nonwaivable fiduciary duty to its clients, but also notes that the parties to an advisory agreement are free to negotiate individualized terms.

(3) new and amended rules under the Exchange Act and the Advisers Act that require broker-dealers and registered investment advisers to provide a brief relationship summary to retail investors in a prescribed format ("Form CRS").

As was originally proposed, both investment advisers and broker-dealers will be required to provide relationship summaries on Form CRS to retail investors at the outset of their relationship. Firms will have to file the Form CRS with the SEC and will be required to periodically update the Form as information becomes outdated or otherwise inaccurate. These Forms will be in a uniform, machine-readable format to assist with comparisons of services from different brokerage and advisory service providers. The Form CRS will include references to investor education resources and "conversation starter" questions for investors to take up with their investment professional. The final Form CRS has been modified from the proposed version to permit broker-dealers and investment advisers to have more flexibility in their descriptions of services. The Form CRS will also include a section for disclosure of disciplinary histories.

(4) an interpretation of section 202(a)(11)(C) of the Advisers Act, which excludes from the definition of "investment adviser" any broker or dealer that provides advisory services "solely incidental" to the conduct of the broker-dealer's business for no special compensation ("Solely Incidental Interpretation").

The SEC approved an Interpretation of the "solely incidental" prong of Section 202(a)(11)(C) of the Advisers Act, which provides an exclusion from the definition of "investment adviser" for certain securities broker-dealers. A broker-dealer whose performance of advisory services is "solely incidental" to the conduct of business as a broker-dealer and who receives no special compensation for those services is not deemed to be an investment adviser.

The newly released Interpretation is intended to confirm and clarify the SEC's prior interpretations of the term "solely incidental." In brief, it states that a broker-dealer's advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the "solely incidental" prong of this exclusion "if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."

Broker-dealers and their associated persons must begin complying with Regulation Best Interest, and broker-dealers and SEC-registered investment advisers will be required to prepare, deliver to retail investors, and file relationship summaries pursuant to Form CRS requirements by June 30, 2020. The Interpretations will be effective immediately upon publication in the Federal Register.

The Department of Labor has indicated informally that it will pursue rulemakings and other guidance that “align” with Regulation BI.

SEC Proposes Amendments to Closed-end Funds and ICI Comment Letter

In March, the SEC released a proposal to modernize its regulations pertaining to registered closed-end funds and business development companies (“BDCs”). The proposed reform would streamline the registration and offering process for these fund types to more closely align with mutual fund regulations. The proposal stemmed from legislation enacted by Congress that aimed to simplify the offering process with a goal of reducing regulatory burdens and boosting the economy. Congress cited a decline in closed-end funds as motivation for the legislation. Highlights of the proposal include a broader reliance on Rule 486 for closed-end funds to obtain automatic effectiveness of annual updates and permitting registration fee payments to take effect immediately. The Investment Company Institute sent a comment letter to the SEC in support of the proposal and offered suggestions to even further tailor the proposed reform to benefit both fund companies and shareholders. The SEC will now review all comment letters prior to enacting any rule amendments.

OCIE Issues Risk Alert Relating to Safeguarding Customer Records and Information in Network Storage

At the end of May, the Office of Compliance Inspections and Examinations (“OCIE”) issued a Risk Alert regarding the safeguarding of customer records and information in network storage. During recent examinations, OCIE identified security risks associated with the storage of electronic customer records and information by registered broker-dealers and investment advisers in various network storage solutions. While most of the network storage solutions offered encryption, password protection, and other security features, examiners noted that firms did not use the available security features in every case. OCIE noted that weak or misconfigured security settings on a network storage device could result in unauthorized access to the information stored there.

During examinations, OCIE staff identified the following that may raise compliance issues with Regulations S-P and S-ID:

- Misconfigured network storage solutions. In certain instances, firms did not adequately configure the security settings on their network storage solutions to protect against unauthorized access. Further, some firms did not have policies and procedures to address the security configuration of their network storage solution. It was often the case that the misconfigured settings were the result of ineffective oversight when the storage solution was initially implemented.
- Inadequate oversight of vendor-provided network storage solutions. In some cases, firms did not ensure by way of policies, procedures, contractual provisions or otherwise, that the security settings on vendor-provided network storage solutions were configured in accordance with the firm's established standards.
- Insufficient data classification policies and procedures. Some firm's policies and procedures did not identify the different types of data stored electronically by the firm and the appropriate controls for each type of data.

The Alert notes that the implementation of a configuration management program that includes policies and procedures governing data classification, vendor oversight and various security features will help to mitigate the risks associated with implementing on-premise or cloud-based network storage solutions. During the examinations, OCIE staff identified several features of effective configuration management programs, data classification procedures and vendor management programs, including:

- Policies and procedures designed to support the initial installation, on-going maintenance, and regular review of the network storage solutions;
- Guidelines for security controls and baseline security configuration standards to ensure that each network solution is configured properly; and
- Vendor management policies and procedures that include, among other provisions, regular implementation of software patches and hardware updates, followed by reviews to ensure that those patches and updates did not unintentionally change, weaken or otherwise modify the security configuration.

OCIE encourages registered broker-dealers and investment advisers to review their practices, policies and procedures concerning the storage of electronic customer information as well as to consider whether improvements are necessary. OCIE further encourages firms to actively oversee any vendors engaged for network storage to determine whether the service provided is sufficient for the firm to meet its regulatory requirements.

SEC Grants Exemptive Relief for Non-Transparent ETF

In May 2019 the SEC granted exemptive relief to Precidian Investments ("Precidian") that would allow Precidian to launch the first actively managed exchange-traded funds ("ETF"s) that do not provide daily portfolio transparency to the general public. The brand and structure approved by the SEC, ActiveShares, is thought to have been licensed by at least 10 fund managers including Legg Mason, Black Rock and Capital Group, among others.

Prior to May, the SEC had conditioned approval of actively managed ETFs on the investment adviser's agreement to publish the ETF's portfolio holdings daily. Daily disclosure was designed to ensure that the ETF's shares trade on the secondary market at a price at or close to its NAV. Many investment advisers complained that such daily disclosures put them at a competitive advantage and would allow others to reverse-engineer and duplicate their investment strategies. Precidian's model will not require daily portfolio transparency. Instead, an ActiveShares ETF's primary listing exchange will disseminate a "verified intraday indicative value" ("VIIV") on one-second intervals throughout the day. Such distribution is intended to provide investors with the underlying value of an ETF basis. "Traditional" ETFs on the other hand, publish an intraday indicative value every fifteen seconds during the trading day. In addition, an ActiveShares ETF's investments will be limited to those securities traded on U.S. exchanges. Among other requirements, an ActiveShares ETF will also be required to: (a) include a legend on its prospectuses and website discussing the differences between ActiveShares and a traditional ETF; (b) comply with Regulation FD; and (c) take certain remedial actions if the ActiveShares ETF exceeds certain premium/discount and bid/ask spreads.

It should be noted that the approval of ActiveShares may only be the first of many models of actively managed, non-transparent ETFs to receive exemptive relief from the SEC. Others such as Eaton Vance, Fidelity, T. Rowe Price, Blue Tractor and Natixis have also filed for exemptive relief based on structures similar to Precidian's but with differing approaches to addressing portfolio transparency. These additional entrants to this market may serve to drive down licensing costs. Additionally, investment advisers will be evaluating the various approaches to addressing transparency to determine which is more efficient to manage as part of the overall ETF offering.

SEC Fines Private Fund Manager for Valuation Discrepancies

The SEC recently imposed a $5,000,000 penalty against a private fund manager for compliance deficiencies resulting in valuation discrepancies within the fund's portfolio. In addition, the SEC imputed personal liability upon the fund manager's chief investment officer ("CIO"), who is required to pay a $250,00 penalty.

The SEC determined that the investment adviser failed to maintain policies and procedures addressing the risk that its traders might mis-value securities in its flagship fund, which was ranked as one of the most consistent performing hedge funds in the country. In addition, the SEC found that the firm failed to maintain procedures intended to prevent its traders from sourcing pricing information derived from pricing quotes the traders previously provided to the related brokerage firms or vendors.

The CIO supervised the valuation of certain assets in the flagship fund and approved valuations the traders noted as "undervalued" with notations to "mark up gradually."

The Chief of the SEC's Enforcement Division's Complex Financial Instruments Unit noted that valuation of client assets is a critical area of concern for investment advisers and that in this particular case, the compliance failures resulted in the traders gradually marking up the assets instead of marking them to market.

SEC Proposes Rule and Form Amendments Revising Financial Disclosures for Fund Mergers

While there are no specific rules or requirements relating to the financial statements of acquired funds, when a registered investment company acquires a registered investment company, the acquiring fund must present financial statements for the acquired fund for the most recent fiscal year and any interim period as required by Form N-14. In addition, the acquiring fund must provide pro forma financial statements. When a registered investment company acquires a private fund, the SEC staff may analogize to the general requirements of Regulation S-X. When a registrant acquires a business, the existing rules requires the registrant to provide audited annual and unaudited interim pre-acquisition financial statements for the acquired business if it is significant to the registrant. Whether an acquisition is significant under the existing rule is determined by applying a series of tests. It is often unclear how to apply the existing rules because they were written for operating companies; not for investment companies.

The SEC has proposed rule and form amendments designed to tailor the financial reporting requirements for investment company acquisitions of other investment companies. Where a fund acquires private fund, the proposal reduces the number of financial statement fiscal periods that must be provided for the acquired fund. The proposal would also eliminate the pro forma

financial statement requirement for investment company acquisitions of other investment companies.

The proposal would eliminate the current pro forma financial reporting requirement for investment companies required by Article 11 of Regulation S-X. In lieu of the pro forma financial information the registrant would be required to provide:

i. A table showing the current fees for the registrant and the acquired fund and pro forma fees, if different, after giving effect to the acquisition using the format prescribed in the appropriate registration statement form;

ii. If the transaction will result in material changes to the acquired fund's portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to reflect the change and narrative disclosure describing the change; and

iii. Narrative disclosure about material differences in financial and operating policies of the acquired fund when compared to the registrant.

The proposal makes conforming changes to *Item 14 – Financial Statements* of Form N-14. Those changes specify that if the investment company to be acquired is a private fund, the registrant must provide the acquired fund's financial statements for only the most recent fiscal year and the most recent interim period.

SEC Releases Framework for "Investment Contract" Analysis of Digital Assets

In April, the SEC released its framework for analyzing whether a digital asset such as an Initial Coin Offering ("ICO") qualifies as "security" subject to U.S. federal securities laws (the "Release"). A "security" includes an "investment contract" as well as other instruments (e.g., stocks, bonds). In the Release, the SEC adopts the three-pronged analysis set forth in the U.S. Supreme Court's *Howey* case to determine whether an "investment contract" exists. Under the so-called "*Howey* test," an asset is considered an "investment contract" when there is (1) the investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits to be derived from the efforts of others. The SEC indicated that the first two prongs of the *Howey* test are clearly satisfied for digital assets. First, digital assets are purchased or otherwise acquired in exchange for value, whether in the form of money or other type of consideration. Second, digital assets have constituted investments in a common enterprise because the fortunes of digital assets investors asset are linked to each other. The SEC indicates, however, that the main issue when analyzing digital assets under the *Howey* test lies in the third prong and the Release includes myriad characteristics that would weigh in favor of determining that a digital asset is an "investment contract," including the following:

- Reliance on the Efforts of Others
  - Does the purchaser reasonably expect to rely on the efforts of a promoter, sponsor, or other third party (each, an "Active Participant" or "AP")?
  - Are the AP's efforts undeniably significant and essential managerial efforts that affect the failure or success of the investment?
- Reasonable Expectation of Profits
  - Does the digital asset give the holder rights to share in the enterprise's income, profits or to realize gains from capital appreciation?
  - Is the digital asset transferrable or traded through a secondary market or platform?
  - How is the digital asset marketed?

The Release also provides a number of additional relevant characteristics specific to the nature of digital assets indicating that the stronger the presence of such considerations, the less likely that the asset meets the *Howey* test. Such considerations include:

- The distributed ledger network and digital asset are fully developed and operational.
- Holders of the digital asset are immediately able to use it for its intended functionality.
- For digital assets referred to as virtual currencies, can they be immediately used to make payments or act as substitutes to real currency?
- Any economic benefit that may be derived from appreciation is incidental to obtaining the right to use it for its intended functionality.

The Release is available at:
https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

SEC Staff Guidance Sets Timeline for Providing Responses to Staff Comments

The SEC's Office of Disclosure Review and Accounting in the Division of Investment Management recently issued guidance regarding their review of certain filings as it relates to the automatic effectiveness rule. Under the automatic effectiveness rule, amendments to mutual fund registration statements take effect automatically 60 days after filing when including material changes in the filing and 75 days after filing when registering a new series fund. From time to time the Staff, in the course of reviewing amendments, will request that mutual fund sponsors delay the automatic effectiveness of a mutual fund's annual update. In the recently

issued guidance the Staff, presumably frustrated that mutual funds are submitting comments shortly before or at the same time as automatic effectiveness, requested that mutual funds file a delaying amendment if a fund is unable to submit responses to Staff comments at least five business days before automatic effectiveness.

Given the potential ramifications of delaying the effectiveness of an update to a registration statement even one day past when it is due, it would be advisable to consider updating timelines to file responses earlier and discussing potential implications with counsel before agreeing to delay effectiveness. An untimely update to a registration statement may leave a fund without an effective registration statement and the possibility of liability, including potential rescission of sale of fund shares, under the Securities Act of 1933, as amended, for selling shares without an effective registration statement. It's also worth noting that halting shares through intermediary channels on very short notice may be almost impossible and most intermediary agreements require one or two months' notice before an offering may be halted.

SEC Provides No-Action Relief for Index-Based Funds to Exceed Diversification Limits

The Staff of the SEC Division of Investment Management (the "Staff") recently issued no-action relief allowing registered open-end and exchange-traded index-based funds to exceed the limits of a "diversified company" as defined in the Investment Company Act of 1940, as amended ("1940 Act") under certain circumstances, without obtaining shareholder approval. The relief is implicated when changes in relative market capitalization and weightings of certain issuers in a fund's benchmark index would cause the fund to exceed the investment limitations for a diversified company if it continued to track the composition of its benchmark index.

The no-action request sought to address the concern that an index-based fund, solely as a result of tracking its unaffiliated broad-based index would no longer be considered a diversified company as a result of a change in the relative market capitalization or index weighting of one or more constituents of the index. This no-action relief would allow index-based funds to continue to invest pursuant to their investment objective without the disruption and expense of obtaining shareholder approval.

The Staff responded that it will not recommend enforcement action against index-based funds that exceed the limits for a diversified company with respect to investments in an issuer or several issuers as necessary to approximate the composition of the fund's benchmark index without obtaining shareholder approval. The index-based fund must:

- Update its registration statement to reflect the fund's ability to exceed such limits and the associated risks thereof, and

- Provide notice of the fund's updated diversification policy to shareholders.

The registration statement updates and shareholder notices must include:

- In the index-based fund's prospectus, the principal investment strategy disclosure must state that the fund may become non-diversified, as defined in the 1940 Act, solely as a result of a change in the relative market capitalization or index weighting of one of more constituents of the benchmark index;
- In the index-based fund's prospectus, the risks associated with the fund becoming non-diversified must be disclosed as a principal risk; and
- In the index-based fund's statement of additional information, the fundamental investment policy concerning diversification must reflect that the fund intends to be diversified in approximately the same proportion as the benchmark index.

In terms of shareholder communication, at a minimum, the index-based fund must post its updated diversification policy to its website, Additionally, the index-based fund must send to shareholders a prospectus supplement or other communication in a separate document, that clearly reflects the updates to the index-based fund's principal investment strategy and risk disclosure and that shareholder approval will not be sought when the index-based fund becomes non-diversified due solely to a change in the relative market capitalization or index weighting of one or more constituents of the benchmark index.

In order to rely on the relief, the index-based fund's benchmark index must have been created by an index provider that is not an affiliated person of the index-based fund, its investment adviser or principal underwriter, or an affiliated person of such persons, and was not created solely for the index-based fund or its affiliated persons.

This no-action relief for funds that track indices allows them to do so on an uninterrupted basis without holding a shareholder vote and an incurring an index tracking error.

Commodity Futures Trading Commission Releases its Enforcement Manual to the Public

Following the lead of the Department of Justice and the Securities and Exchange Commission, in May the Commodity Futures Trading Commission (the "CFTC") made its Enforcement Manual available to the public. Publication of the manual will provide market participants, industry professionals and others with valuable insight into how the CFTC detects and pursues violations and commences investigations. The manual also discusses other topics such as initiatives regarding self-reporting and remediation, the CFTC's cooperation with other

enforcement agencies and the process for issuing Wells Notices. According to a CFTC statement, the purpose of the move it to promote fairness, increase predictability and enhance respect for the rule of law.

Liquidity Risk Management Updates

Recently ACA Compliance Group completed it second survey regarding how funds/advisors are implementing the new requirements. Here is a summary of their results.

- 90% of respondents are designating a committee structure at the advisor as the program administrator
- Membership in the committee includes investment, trading, risk, compliance, operations and legal
- 62% indicated that the investment advisor is charged with the classification requirement with 76% using third-party vendors to support their efforts.
- 52% follow fund adopted policies and procedures vs. 42% following investment advisor policies and procedures.
- 71% are completing the classification monthly
- 47% have set reasonably anticipated trading size or "RATS" at 0% to 5% with another 15% setting it at ^% to 10%.
- 48% of funds will set the market price impact input based on a percentage of trading volume.

In addition, the SEC provided guidance on how to apply liquidity requirements and reporting when there is an extended foreign holiday, such as the Chinese New Year or the recent Japanese coronation. In the guidance, the SEC stated that they believe that while securities in those markets would become temporarily illiquid, these situations are usually known in advance and can be addressed in the Liquidity Risk Management Program. The program should address how the fund will deal with those situations and how the board and other relevant parties will be notified. If this process is followed, the Staff would not object if a fund did not file a N-LIQUID for an investment that becomes illiquid solely due to the market closure.

DC Circuit Clarifies Meaning of "Willful" under Section 207 of the Investment Advisers Act of 1940

In a recent case, the DC Circuit Court concluded that a finding of "willful" action under Section 207 of the Investment Advisers Act of 1940 (the "Act") requires that the actor "subjectively intended to omit material information." By doing so, the Court confirmed the important distinction that an investment adviser could not be held liable under Section 207 of the Act for mere negligence. In its decision, the Court reiterated the importance of full and fair disclosure in Form ADV. It is also important to note that many sections of the Act only require proof of simple negligence, so the Court's decision does not impact those types of violations.

Delaware Continues to Conduct Unclaimed Property Audits

The State of Delaware continues an aggressive campaign aimed at identifying companies who may have failed to timely escheat unclaimed assets to the State. Delaware has used a two-pronged approach to this campaign: an unclaimed property voluntary disclosure agreement program and non-voluntary audits conducted by third party auditors. For the voluntary component, Delaware has sent out around 300 requests in the last year, allowing companies to self-report delinquencies and possibly avoid heavy penalties and interest. However, the third-party audits do not come with the possibility for waived fees and can be costly. Additionally, the third-party audit firms usually also contract with other states, so there is a risk that the audit could expand beyond Delaware.

TAX UPDATE

Regulatory

U.S. Supreme Court holds that North Carolina cannot tax NY-based trust whose only contact with state was a resident beneficiary with no guaranteed right to distributions

The U.S. Supreme Court held in North Carolina Dept. of Rev. v Kimberley Rice Kaestner 1992 Family Trust that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it.

Joseph Lee Rice III formed a trust for the benefit of his children in his home State of New York and appointed a fellow New York resident as the trustee. The trust agreement granted the trustee "absolute discretion" to distribute the trust's assets to the beneficiaries. In 1997, Rice's daughter, Kimberley Rice Kaestner, moved to North Carolina. The trustee later divided Rice's initial trust into three separate sub-trusts, and North Carolina sought to tax the Kimberley Rice Kaestner 1992 Family Trust (Trust) – formed for the benefit of Kaestner and her three children- under a law authorizing the State to tax any trust income that "is for the benefit of" a state resident, N.C. Gen. Stat. Ann §105-160.2. The State assessed a tax of more than $1.3 million for tax years 2005 through 2008. During that period. Kaestner had no right to, and did not receive, any distributions. Nor did the Trust have a physical presence, make any direct investments, or hold any real property in the State. The trustee paid the tax under protest and then sued the taxing authority in state court, arguing that the tax as applied to the Trust violates the Fourteenth Amendment's Due Process Clause. The state courts agreed, holding that the Kaestners' in-state residence was too tenuous a link between the State and the Trust to support the tax.

The U.S. Supreme court held that the Due Process Clause limits States to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state. Wisconsin v. J.C. Penny Co., 311 U.S. 435, 444. Compliance with the Clause's demands "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that "the income attributed to the State for tax purposes…be rationally related to "values connected with the taxing State,"" Quill Corp. v. North Dakota, 504 U.S. 298, 306. That "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action. Id., at 307. Pp. 5-6.

In the trust beneficiary context, the Court's due process analysis of state trust taxes focuses on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets.

Cases such as Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U.S. 83; Brooke v. Norfolk, 277 U.S. 27; and Maguire v. Trefry, 253 U.S. 12, reflect a common principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax. Safe Deposit, 280 U.S., at 91. Similar analysis also appears in the contest of taxes premised on the in-state residency of settlors and trustees. See, e.g., Curry v. McCanless, 307 U.S. 357. Pp. 6-10.

Applying these principles here, the residence of the Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax. First, the beneficiaries did not receive any income from the Trust during the years in question. Second, they had no right to demand Trust income or otherwise control, possess, or enjoy the Trusts assets in the tax years at issue. Third, they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Pp. 10-13.

IRS Issues Final Regulations on Corporate Transfers of Property to RICs and REITs

The IRS issued final regulations effecting the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986 and preventing abuse of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act). The final regulations impose corporate-level tax on certain transactions in which property of a C corporation becomes the property of a REIT. The final regulations affect RICs, REITs, C corporations the property of which becomes the property of a RIC or a REIT, and their shareholders.

In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), the Supreme Court held that corporations generally could distribute appreciated property to their shareholder without the recognition of any corporate-level gain (*General Utilities* doctrine). Beginning with legislation in 1969 and culminating in the Tax Reform Act of 1986, Congress repealed the *General Utilities* doctrine by enacting Internal Revenue Code ("IRC") Section 336(a) to apply gain and loss recognition to liquidating distributions. IRC Section 337(d) directs the Secretary of the Treasury ("Secretary") to prescribe regulations that are necessary or appropriate to carry out the purposes of *General Utilities* repeal, including "regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations) including … part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity…"

On June 8, 2016 the Department of the Treasury ("Treasury Department") and the IRS published temporary regulations effecting the repeal of the General Utilities doctrine as applied to certain transfers of property to RICs and REITs. The text of the Temporary Regulations served as the text for part of the 2019 Proposed Regulations. The Treasury Department and the IRS adopted the 2016 Proposed Regulations, in part, in final regulations on January 18, 2017. The preamble to the 2017 Final Regulations indicated that the Treasury Department and the IRS would continue to study other issues addressed in the Temporary Regulations and the 2016 Proposed Regulations. In response to comments received addressing the Temporary Regulations and the 2016 Proposed Regulations, the Treasury Department and the IRS published a notice addressing the potential over-inclusion of gain on March 26, 2019 (2019 Proposed Regulations).

Proposed regulation would provide that the automatic deemed sale rule applies to a C corporation if, (i) the C corporation engages in a conversion transaction involving a REIT during the twenty-year period beginning on the date that is ten years before the date of a related section 355 distribution and (ii) the C corporation engaging in the related section 355 distribution is either the distributing corporation or the controlled corporation, or a member of the separate affiliated group of the distributing corporation or the controlled corporation. A conversion transaction occurs through (i) the qualification of a C corporation as a RIC or a REIT, or (ii) the transfer of property owned by a C corporation to a RIC or a REIT.

The 2016 Proposed Regulations would define the term "converted property' as "property owned by a C corporation that becomes the property of a RIC or a REIT and any other property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the property owned by a C corporation that becomes the property of a RIC or a REIT.

A commenter inquired whether the Treasury Department or the IRS intended the 2016 Proposed Regulations to override section 856(c)(8). The 2016 Proposed Regulations do not override section 856(c)(8). Accordingly, if section 856(c)(8) would prevent a distribution corporation or a controlled corporation from electing REIT status, no gain would be recognized, absent further action (for example, a merger of the distributing corporation or the controlled corporation into a REIT).

U.S. Treasury Department and IRS Propose Regulations Regarding Withholding on Certain Payments from Retirement Accounts (Including Payments Delivered Outside of U.S.)

The U.S. Department of the Treasury ("Treasury") and IRS issued proposed regulations regarding withholding on certain periodic and nonperiodic distribution under Internal Revenue Code ("IRC") section 3405, other than eligible rollover distributions. This regulation would affect payors and payees of these distributions.

Payors of any periodic payments or non-periodic distributions are generally required to withhold income tax from the payments unless an individual generally elects not to have withholding apply with respect to the periodic payments or non-periodic distributions made to the individual. A periodic payment is defined as a designated distribution that is an annuity or similar periodic payment and a nonperiodic distribution is defined as any designated distribution that is not a periodic payment. A designated distribution generally is defined as any distribution or payment from or under any employer deferred compensation plan, an individual retirement plan, or a commercial annuity. An employer deferred compensation plan is defined as any pension, annuity, profit sharing, or stock bonus plan or other plan deferring the receipt of compensation and a commercial annuity is defined as an annuity, endowment, or life insurance contract issued by and insurance company licensed to do business under the laws of any State.

Certain amounts or payment are not a "designated distribution" for purposes of withholding. Any amount that is subject to withholding (relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount or which would be so subject but for a tax treaty is not a designated distribution.

IRC section 3405(e)(13)(A) provides generally that, in the case of any periodic payment or nonperiodic distribution that is "to be delivered outside of the United States and any possession of the United States," no election may be made with respect to such payment, with the result that withholding may not be waived.

IRC section 3405(e)(13)(B) provides that section 3405(e)(13)(A) does not apply if the recipient certifies to the payor, in such manner as the Secretary of the Treasury may prescribe, that the recipient is not (i) a United States citizen or a resident alien of the United States, or (ii) an individual whose expatriation date is before June 17, 2008.

IRS Notice 87-7 provides guidance under IRC section 3405(e)(13)(A) to payors of designated distribution with respect to their duty to withhold income tax from such distributions. Notice 87-7 specifies that, if a payee has provided the payor with a residence address outside of the

United States, the payor is required to withhold income tax from designated distributions to the payee. If a payee has provided the payor with a residence address within the United States, the payor is required to withhold income tax from these distributions to the payee unless the payee has elected no withholding in accordance with the applicable provision of section 3405. If a payee has not provided the payor with a residence address, the payor is required to withhold income tax from designated distributions; included within this category is a payee who had provided the payor with an address for the payee's nominee, trustee, or agent without also providing the payee's residence address.

For purposes of IRC section 3405(e)(13)(A), the proposed regulation treats an APO, FPO, or DPO address as an address located within the United States. The proposed regulation would impose new withholding requirements on payors regarding certain payees who have provided the payor with a residence address located within the United States. The proposed regulation requires payors to withhold in certain circumstances when a payee provides a residence address located within the United States but also provides payment instructions indicating that the funds are to be delivered outside the United States.

Unless IRC section 3405(e)(13)(B) applies, if the payee's residence address that is provided to the payor is located outside of the United States, the payor is required to withhold income tax under IRC section 3405 from any designated distribution without regard to the delivery instructions and without regard to any attempt to elect no withholding. The same requirement to withhold income tax under IRC section 3405 would apply if a payor has not provided a residence address to a payee. A payee who has provided the payor with an address for the payee's nominee, trustee, or agent without also providing the payee's residence address has not provided a residence address for purposes of this regulation.

These rules are consistent with the approach in IRS Notice 87-7, which uses the residence address of the payee in order to determine whether a taxpayer is permitted to make an election not to have withholding apply. The Department of the Treasury and the IRS have determined that this interpretation articulated in IRS Notice 87-7 should be retained because it provides an administrable standard that has been relied upon for many years, is consistent with the legislative history, and appropriately addresses tax avoidance concerns.