Industry Trends – February 2019

Industry Statistics – Mutual Funds

Fund Category	Net Assets (in billions) Dec-18	Net Assets (in billions) Sept-18	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	$9,224.4	$10,874.7	(15.2%)	($1,650.3)	($134.0)	($1,516.3)
Hybrid	$1,382.8	$1,519.0	(9.0%)	($136.2)	($49.1)	($87.1)
Taxable Bond	$3,386.1	$3,486.0	(2.9%)	($99.9)	($111.6)	$11.7
Municipal Bond	$675.4	$680.0	(0.7%)	($4.6)	($11.2)	$6.6
Money Market	$3,037.1	$2,863.6	6.1%	$173.5	$164.2	$9.3
Total	$17,705.8	$19,423.3	(8.8%)	($1,717.5)	($141.7)	($1,575.8)

- Due to market declines, **stock** fund assets decreased during the quarter by $1,650.3 billion. For the quarter ended December 31, 2018, market depreciation was $1,516.3 billion compared to an appreciation of $490.9 billion for the quarter ending September 30, 2018. The net assets for stock funds decreased from $10,874.7 billion as of September 30, 2018, to $9,224.4 billion at the end of December 2018.

- **Hybrid** fund assets decreased from $1,519.0 billion as of September 30, 2018, to $1,382.8 billion as of December 31, 2018. This compares to an increase of $23.2 billion in the third quarter of 2018. The increase was the result of market depreciation of $87.1 billion and net outflows of $49.1 billion.

- **Bond** funds had net outflows of $122.8 billion for the quarter ended December 31, 2018, compared to the previous quarter inflows of $41.9 billion. Assets for all bond funds decreased $104.5 billion for the quarter ended December 31, 2018, which included market appreciation of $18.3 billion.

- **Money market** funds had net inflows of $164.2 billion for the three months ended December 31, 2018, compared to the previous quarter inflows of $33.9 billion. Money market fund net assets, over the three-month period, increased from $2,863.6 billion as of September 30, 2018, to $3,037.1 billion as of December 31, 2018.

Source: Investment Company Institute website

REGULATORY UPDATE

Risk-Based Examination Initiatives Focused on Registered Investment Companies

The Office of Compliance Inspections and Examinations ("OCIE") issued a risk alert on November 8, 2018 concerning Risk-Based Examination Initiatives Focused on Registered Investment Companies. One of the initiatives noted is side-by-side management of mutual funds and private funds, and the conflicts of interest involved when advisers provide advice to both mutual funds and private funds, especially when managed with similar strategies and/or but the same portfolio managers. The OCIE will focus on:

- Policies and procedures for addressing conflicts of interest and other risks associated with side-by-side management;
- Controls for ensuring appropriate brokerage, best execution and trade allocation practices, including trade aggregation and allocation of investment opportunities among the side-by-side funds;
- Allocation practices for various fees and expenses; and
- Disclosures to investors and funds' boards.

The OCIE staff reminds advisors about making sure policies and procedures are in place to treat all accounts the same. Investment advisors new to managing a mutual fund must implement trade error and cross-trade policies. Sub-advisors to mutual funds may be new to registered funds but must be aware of the potential conflicts of interest between the private funds they manage as well as the registered funds they advise. Fund boards are responsible for reviewing and approving subadvisors' policies and procedures pertaining to cross-trades and self-dealing, among others.

The OCIE staff also will focus on index funds that track custom-built indexes. A custom-built index is created an/or maintained by an index provider for a single fund or sponsor. The custom-built index is used to select the fund's investments and may result in more complex or targeted investments than those associated with traditional index funds. During such an examination, the OCIE staff with seek to:

- Review how the portfolios are managed compared to the fund's disclosures to investors;
- Understand the nature of services provided by the index providers and the sufficiency of disclosures made to the funds' boards regarding the index providers;
- Assess whether there are any conflicts of interest between the index providers and advisers and whether they are addressed; and
- Review the effectiveness of the funds' compliance programs for portfolio management and their boards' oversight of such programs.

In addition, the OCIE staff will also seek to understand the factors contributing to mutual funds' aberrational underperformance relative to their peer groups. Such factors will include asset allocation and security selection. The OCIE staff will also review the effectiveness of the mutual funds' compliance programs and whether the mutual funds' board are conducting appropriate oversight of their compliance programs. The OCIE staff's review of the mutual funds' compliance programs will include whether the funds or their advisers are:

- Investing consistent with the mutual funds' investment objectives and strategies as disclosed in their prospectuses;
- Using marketing materials that contain adequate disclosures related to the mutual funds' investment objectives and risks;
- Allocating investment opportunities to the mutual funds consistent with the advisers' fiduciary duty; and adhering to applicable requirements when borrowing or investing the mutual funds' portfolios in instruments that may leverage assets.

SEC Sends Sweep Letters Relating to Share-Class Selection and Revenue Sharing

Multiple firms reported receiving document requests from the SEC relating to the firms' share-class selection and revenue sharing practices. The requests expanded the SEC's previous share-class initiative to also scrutinize firms' revenue sharing arrangements. Information requested from the SEC included policies and procedures covering share-class selection and fees, policies and procedures on revenue sharing arrangements, historical data on Rule 12b-1 fees paid by advisory clients, and any documentation supporting changes to firms' policies on these matters in the last five years. The SEC's requests follow a four-month period of invited self-reporting to the SEC, and the requests were likely sent to firms who did not self-report violations during that period.

Update: Digital Asset Securities

In December 2018, the SEC announced the settlement of two enforcement actions involving Paragon and AirFox that imposed registration requirements and civil penalties against issuers of initial coin offerings ("ICOs") for failing to register the offerings under Section 5 of the Securities Act of 1933, as amended (the "Securities Act"). These are the first enforcement actions that impose civil penalties against issuers of digital asset tokens in ICOs for violating the registration requirements of the federal securities laws. On the same day, the SEC's Divisions of Corporation Finance, Investment Management and Trading and Markets issued a joint statement (the "Joint Statement") highlighting the SEC's enforcement actions and reinforcing key points regarding digital asset securities.

In December 2017, the SEC ordered a token issuer to discontinue its token offering and refund investors without imposing civil penalties. With respect to the December 2018 settlements, in addition to civil penalties, the issuers were required to undertake remediation efforts, including the registration of the tokens as securities under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). In the December 2018 actions, the SEC determined that the token presales constituted the offer and sale of securities under the Securities Act. In the respective orders, the SEC restated its position that the correct test for the determining whether a digital asset is a security is the *Howey* test. The SEC concluded that token sales in both cases were "investment contracts" that must be offered pursuant to the SEC registration requirements or an exemption. At that time, no digital asset security had been registered under the Exchange Act, thus it is unclear from the orders how the issuers will address their disclosure requirements and the scope of information that will be provided.

AirFox and Paragon are also required to provide an SEC-approved claim form to all who purchased tokens in the presale or ICO. The purchasers are entitled to receive their consideration paid plus interest, although the SEC did not specify whether the consideration would be returned in the form it was originally received.

The Joint Statement provides the summaries of enforcement actions and the reinforcement of the SEC's positions regarding unregistered ICOs:

- Offers and sales of unregistered digital assets – enforcement actions have focused on whether the assets are securities;
- Investment vehicles and investment advisers investing in digital asset securities – the Investment Company Act of 1940, as amended (the "1940 Act") requires the registration of and regulatory framework for pooled investment vehicles investing in digital asset securities; and
- Trading of digital asset securities – the SEC discussed the application of the federal securities laws governing securities exchanges and broker-dealers to companies operating platforms for trading digital assets or engaging in other activities that facilitate the trading of these assets.

Digital Assets and OFAC

The U.S. Treasury's Office of Foreign Assets Control ("OFAC") has authority over a broad segment of the market and administers and enforces U.S. sanctions laws and asserts jurisdiction over any entity organized under the laws of the United States as well as any U.S. citizens and any person physically located in the United States. U.S. persons must block all property in which an individual or entity on OFAC's List of Specially Designated Nationals and Blocked

Persons (“SDN List”) has an interest. U.S. persons are generally prohibited from transacting with anyone on a SDN List.

In March 2018, OFAC issued five frequently asked questions concerning digital currencies and sanctions compliance. OFAC indicated that it would target the use of digital currencies or other emerging payment systems to effect prohibited transactions and evade U.S. sanctions. OFAC added that compliance obligations for U.S. persons are not any different when they are dealing with virtual currencies. Thereafter, OFAC issued administrative subpoenas to various businesses in the digital asset space for reports of blocked transactions or accounts. OFAC did admit there are unique challenges for companies operating in the digital asset space and that it may add digital currency addresses to the SDN List. In November 2018, OFAC formally identified two digital asset addresses associated with two Iranian SDNs. Short of providing digital asset addresses, OFAC compliance is challenging to those regularly engaged in cryptocurrency transactions.

OCIE Sets 2019 Examination Priorities

The Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission announced its 2019 examination priorities in early November 2018. The priorities are:

- Matters of importance to retail investors, including seniors and those saving for retirement;
- Compliance and risk in registrants responsible for critical market infrastructure;
- Select areas and programs of FINRA and MSRB;
- Digital assets;
- Cybersecurity; and
- Anti-Money Laundering

The OCIE notes that the priorities are not exhaustive and other issues will be addressed during examinations. These priorities reflect the OCIE’s assessment of certain risks, issues and policy matters resulting from market and regulatory developments, information gathered from examinations, as well as other sources, including tips, complaints, referrals and coordination with other regulators.

SEC Issues Proposals Regarding Fund-of-Funds Arrangements

On December 19, 2018 the SEC’s Commissioners voted to propose a new rule and amendments intended to revise the applicable regulatory framework for funds that invest in other funds. Currently under Rule 12d1-2 of the Investment Company Act of 1940, as amended (the “1940 Act”), funds cannot own more than 3% of the of the shares of another investment company registered under the 1940 Act without prior exemptive relief. As a result, recognizing that

exemptions are in the public interest because fund of fund arrangements can be an efficient way for investors to gain exposure to certain markets or asset classes, the SEC has issued numerous exemptive orders. However, completion of the exemptive order process can take time and results in increased costs when a fund desires to exceed the limits otherwise set forth in the applicable provisions of the 1940 Act. Additionally, the terms of such exemptive orders have not been the same and, as a result, some arrangements can be more onerous than others. According to the SEC's proposal roughly one half of registered funds invest in other funds. Furthermore, among existing funds of funds, approximately half invest at least 5% of their assets and other funds and 25% have 90% or more of their assets in other products.

Seeking to promote consistency for fund-of-funds arrangements, the SEC has proposed to rescind Rule 12d1-2 and prior exemptive orders permitting fund of fund arrangements with limited exceptions. Recognizing the potential value of fund-of-funds arrangements along with the desire to prevent potential abuses by acquiring funds through an undue use of influence and control, the SEC proposed new Rule 12d1-4. The proposed rule will prohibit an acquiring fund from controlling an acquired fund and would require an acquiring fund that holds more than 3% of an acquired fund to vote those securities in a prescribed manner to minimize influence. Rule 12d1-4 would also prohibit an acquiring fund owning more than 3% of an acquired fund from redeeming more than 3% of the acquired fund's total outstanding shares in any 30-day period. The proposed rule includes conditions designed to prevent duplicative and excessive fees and generally would prohibit funds from creating complex three-tier fund-of-funds structures, except in limited circumstances. Worth noting is that the proposals also include amendments to Form N-CEN to require funds to report whether they relied on Rule 12d1-4 or the statutory exception in Section 12(d)(1)(G) of the 1940 Act.

These proposals have a 90-day comment period beginning on the date of publication in the Federal Register.

SEC Brings First Enforcement Case Against Robo-Advisors

In December, the SEC brought its first enforcement case against two robo-advisory firms alleging the firms provided misleading information relating to their advisory strategies and violated SEC advertising rules relating to their services. The two firms paid over $300,000 in fines for violations that included the use of misleading performance comparisons, the use of social media to share testimonials and payments to bloggers in exchange for referrals without disclosing such arrangements. One of the firms wound down its business and no longer has assets under management.

SEC Updates Frequently Asked Questions on Fund Reporting

In November, The SEC updated its frequently asked questions and answers (“FAQ”) on the new fund reporting rules. The updated FAQs address:

- When a fund should respond to items in Form N-CEN related to their liquidity risk management program;
  - The SEC clarified that a fund with a fiscal year-end before December 1, 2018, does not include a response to the two items on Form N-CEN.
- Whether a fund may report monthly returns on Form N-PORT without deducting sales loads and redemption fees;
  - The updated FAQs indicated that the Staff would not object to funds exporting returns without sales loads and redemption fees and it should be noted in Part E of the report.
- When a fund would discontinue filing forms N-PORT and N-CEN upon liquidation or merger;
  - If a fund no longer has shareholders or investors, then a fund is not required to file N-PORT reports. Form N-CEN must be filed until the fund deregisters with the SEC.
- Whether a fund that has an effective registration statement but has not yet been publicly offered must file Form N-PORT;
  - An N-PORT is not required to be filed until 30-days after the month that a fund first offers shares to the public.

SEC Issues Sanctions for Unlawful Cross-Trades

In October, the SEC announced the settlement of an enforcement action against an investment adviser and its portfolio manager for engaging in unlawful cross-trades. The investment adviser and its portfolio manager received a cease and desist order, and each paid a monetary fine to the SEC as a result of the proceedings. The violations stem from the portfolio manager effectuating cross-trades between the accounts of clients, including those of registered investment companies and accounts affiliated with registered investment companies. These trades resulted in certain advisory clients receiving favorable treatment without proper disclosure to all clients in contravention of the investment adviser’s and portfolio manager’s fiduciary duty to all clients. Because of the enforcement investigation, the SEC also found that the investment adviser failed to adopt adequate policies and procedures to prevent the illegal cross-trades, failed to adequately supervise the portfolio manager who placed the cross-trades and included material misstatements or omissions in the investment adviser’s Form ADV filed with the SEC.

ICI Responds to SEC Regarding Summary Shareholder Financial Reports

Last June, the SEC issued a request for comment on enhancing disclosures by funds. The request was part of a long-term initiative to improve the investor experience by updating the design, delivery, and content of fund disclosure for the benefit of individual investors. The SEC requested comments to learn how investors use these disclosures and how they believe funds can improve disclosures to help investors make investment decisions.

Responding to this request, The Investment Company Institute ("ICI") developed a template for a summary shareholder report. The key components are:

- A bullet point list of performance highlights, including a description of the market in which the fund invests, and any dynamics that may have affected performance during the period.
- A bar chart showing the fund's total return and expense ratio for a specific share class and potentially including performance against certain benchmarks.
- Portfolio holdings represented in graphs, which can include top 10 holdings, style box, asset allocation, geographical concentration or sectors.
- Average annual total returns over a 1, 5, and 10-year period, as well as a table showing index performance over those periods.
- Expense example calculating using a $1,000 base investment. The table would show the dollar amount of expense over the past 6-months, along with one-line simplified narrative disclosure.

ICI Releases 2018 Profile of Mutual Fund Shareholders

The Investment Company Institute ("ICI") conducts an annual survey to track US households' ownership of mutual funds and to gather information on their demographic and financial characteristics. The report found that the "typical" mutual fund shareholder as:

- Most households that owned funds were headed by individuals in their peak earnings and savings years. Sixty two percent of mutual fund owning investors were between the ages of 35 and 64.
- Almost half of investors owning mutual funds had incomes of less than $100,000.
- Mutual fund-owning households often held several funds. The most common were equity funds. Among households owning mutual funds 82% held more than one fund and 88% owned equity funds.
- Almost all mutual fund investors were focused on retirement savings.
- Employer-sponsored retirement plans are the gateway to mutual fund ownership. Sixty-five percent of households that purchased their first fund in 2010 or later purchased through an employer-sponsored retirement plan.

- Millennial households owning mutual funds are more likely to hold funds only inside employer-sponsored plans.

The full research paper can be found at: https://www.ici.org/pdf/per24-09.pdf

Compliance Issues Associated with the Cash Solicitation Rule

On October 31, 2018, the Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert addressing investment adviser compliance issues related to the cash solicitation rule. Generally, investment advisers registered under the Investment Advisers Act of 1940, as amended ("Advisers Act") may not directly or indirectly pay a cash fee to any person who solicits clients for the adviser (a "solicitor") unless the arrangement with the solicitor complies with certain conditions. Among other requirements, the cash fee must be paid in accordance with a written agreement with the adviser.

The Cash Solicitation Rule includes the following requirements when an adviser uses a third-party solicitor:

- The solicitation agreement must contain certain provisions, such as a description of the solicitation activities to be conducted and the compensation to be received;
- The solicitation agreement must require that at the time of any solicitation activities, the solicitor is to provide the potential client with a copy of: (i) the adviser's brochure as required the Rule 204-3 of the Advisers Act and (ii) a separate written disclosure containing required information that highlights the solicitor's financial interest in the client's choice of an adviser;
- The adviser must receive from the client, at or before the time of entering into any written or oral agreement with the client, a signed and dated acknowledgment that the client received the adviser brochure and the solicitor disclosure document; and
- The adviser must make a bona fide effort to ascertain whether the solicitor has complied with the solicitation agreement and must have a reasonable basis to believe that the solicitor has complied.

The most common compliance issues identified by the OCIE staff related to the Cash Solicitation Rule include:

- Solicitors not providing solicitor disclosure documents to prospective clients or providing incomplete disclosure documents.
- Advisers not receiving signed and dated acknowledgments on a timely basis.
- Advisers paying cash fees to solicitors without a solicitation agreement in effect or making payment pursuant to an agreement that did not contain required provisions.

- Advisers not making sufficient effort to ascertain whether third-party solicitors complied with the solicitation agreements and having no reasonable basis for believing that the third-party solicitors have complied with the solicitation agreement.

Raymond James A-Share Load Waiver Prospectus Language

Based on recent filings, effective on or about March 1, 2019, shareholders purchasing a Wells Fargo Fund or Franklin Fund shares through a Raymond James platform or account will be eligible for front-end sales load waivers on Class A shares purchased in an investment advisory program. The filings provide more details about how investors can avoid paying a front-end load on A shares. This is similar to other broker-dealer-specific disclosures that fund managers have added to their fund literature.

The distributors have been pushing for changes to waiver policies. Scores of cases have been brought against firms by the Financial Industry Regulatory Authority and the Securities and Exchange Commission for placing customers in Class A shares without fee waivers. In response to these fines and enforcement proceedings, many distributors have required all managers on their platforms to add language to their prospectuses so that their clients get uniform specific terms for specific share classes.

Fund Boards May Rely on CCO Representations with Respect to Compliance with Rules 10f-3, 17a-7 and 17e-1

Sections 10(f), 17(a) and 17(e) of the Investment Company Act of 1940, as amended (the “1940 Act”), generally prohibit certain transactions between registered funds and such fund’s affiliated persons. Rules 10f-3, 17a-7 and 17e-1 provide exemptive relief from the statutory prohibitions if the fund’s board satisfies certain conditions. These conditions include, without limitation, that the board determines, at least quarterly, that all transactions are effectively in compliance with procedures designed to promote compliance with the requirements of such exemptions. In response to a letter from the Independent Directors Council, the SEC’s Division of Investment Management has stated that the Commission would not recommend enforcement action for violations of Sections 10(f), 17(a) or 17(e) of the 1940 Act if the fund’s board receives at least quarterly a written representation from the fund’s CCO that transactions effected in reliance on one of the aforementioned section’s exemptive rules complied with procedures adopted by the board. This reliance on the CCO’s determination would be instead of the board itself determining compliance with such procedures on a general basis. The SEC stated that allowing the CCO to determine such compliance “is consistent with the Commission’s approach in adopting Rule 38a-1; and would allow boards to avoid duplicating certain functions commonly performed by, or under the supervision of, the CCO.”

Requirement for California Companies to Include Women on Their Boards Likely Doesn't Apply to Mutual Funds

The state of California recently passed a law requiring that public companies with principal executive offices based in California include at least one female director on their boards of directors by the end of this year. The law also includes enhanced requirements for larger boards with staggered implementation deadlines. The law's passing raised many legal questions, one of which being whether the law applied to open-end mutual funds or exchange traded funds. Experts have noted that the law specifically references public corporations with shares listed on a major U.S. stock exchange. However, most mutual funds and exchange traded funds are organized as trusts rather than corporations, therefore putting into question the law's applicability to these entities. While the application of the new law to certain investment companies is debated, many have argued that fund boards should focus on inclusion and diversity of composition regardless of state by state legislation.

SEC Releases Risk Alert on Best Execution Oversight

The SEC recently released a risk alert on best execution oversight to further illustrate investment adviser's best execution obligations and highlight common best execution compliance issues observed by the SEC. The risk alert, which identifies common scenarios where investment advisers have failed in their best execution duties, can help fund directors identify appropriate questions to ask to better understand a firm's best execution policies and procedures.

The risk alert can be found here: https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf

FINRA Disciplines J. P. Morgan Over Rebalancing Issues

J.P. Morgan Securities LLC ("JPMS") discovered that a vendor was not rebalancing certain accounts and that an upgrade by the vendor caused the accounts not to rebalance at the appropriate time. JPMS neither conducted testing after the technology changes nor had any other supervisory procedures in place so multiple billing errors went undetected. JPMS failed to monitor how its vendor calculated fess and rebates therefore approximately $3.1 million in erroneous fees were assessed in more than 150,000 accounts.

Without admitting or denying the findings, JPMS agreed to (i) certify in writing to the FINRA Department of Enforcement that it had engaged in a risk-based review of client facing third-party vendors and (ii) establish systems and policies and procedures designed to achieve compliance with FINRA and NASD rules to settle the charges. FINRA took disciplinary action however decided to not impose a monetary sanction on JPMS because it self-reported the supervisory failures and subsequently began its own examination. Additionally, FINRA stated that JPMS took significant steps to correct the inadequacies in the system and that JPMS paid restitution of $4,620,140 to impacted customers.

ACCOUNTING UPDATE

Deloitte Releases 16th Annual Fair Valuation Pricing Survey

Deloitte released the 16th Annual Fair Valuation Survey. Key findings were:

- Fund groups have started to add automation in the analysis of valuations to improve effectiveness and efficiencies of the valuation process.
- Funds are beginning to incorporate valuation into new liquidity tools.
- As investment strategies have expanded so has the number of pricing sources used by fund groups.
- 55% of fair-value firms are using a zero trigger for fair value foreign investments
- 42% of firms holding private equities calibrate their valuation models and related assumptions to equal initial transaction price and/or subsequent rounds of relative financing.

The complete survey can be found at:

https://www2.deloitte.com/us/en/pages/financial-services/articles/annual-fair-valuation-survey.html#

TAX UPDATE

Regulatory

IRS Issues Guidance on Section 817(h) Diversification Requirement and Single Security Initiative

The IRS has issued IRS Revenue Procedure 2018-54 that provides guidance and procedural rules for taxpayers that hold investment in one or more segregated asset accounts on which variable contracts are based, to allow these taxpayers to elect to treat certain mortgage-backed securities as having deemed issuers for purposed of the IRS diversification requirements under Internal Revenue Code ("IRC") Section 817(h).

Under the direction of the Federal Housing Finance Agency ("FHFA"), the Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac") and the Federal National Mortgage Association ("FNMA" or "Fannie Mae"), will develop a common mortgage-backed security (the "Single Security Initiative"). As part of the Single Security Initiative, key features and terms of Freddie Mac's securities will be aligned with those of Fannie Mae's securities to create new Uniform Mortgage Backed Securities ("UMBS"). UMBS will be issued by both Freddie Mac and Fannie Mae with substantially similar terms.

UMBS would trade primarily in the "To-Be-Announced" ("TBA") market. When a market participant enters into an unstipulated TBA trade to acquire UMBS, it will not know if the issuer is Fannie Mae or Freddie Mac until 48 hours prior to delivery. If an insurance company enters into unstipulated trades to acquire the UMBS securities for inclusion in a segregated asset account on which one or more contracts by the company are based, if the segregated asset account is already heavily invested in securities issued by Fannie Mae or Freddie Mac, an acceptance of the additional securities of an issuer may jeopardize the segregated asset account's satisfaction of the diversification requirements.

Revenue Procedure 2018-54 allows a taxpayer to make a deemed-issuance ratio election with respect to its generic UMBS securities to the extent that an electing taxpayer's generic securities are held in a segregated asset account on which a variable contract issued by the taxpayer or by some other person is based. If an electing taxpayer holds a generic UMBS security, that security is deemed to be issued in part by Fannie Mae and in part by Freddie Mac. The portions deemed issued by each are determined by the deemed-issuance ratio that was applicable to the year in which the taxpayer entered into the TBA contract under which the generic UMBS security was to be delivered, except to the extent that the taxpayer is a buyer and acquired a generic UMBS security in a succession transaction, then the security retains the same deemed-issuance ratio in that taxpayer's hands that it had in the hands of the predecessor. The deemed-issuance ratio continues to apply for as long as the taxpayer holds the security.

FATCA

IRS Issues Proposed Regulations to Ease FATCA Withholding Rules

The IRS issued proposed regulations on December 13, 2018, amending regulations under Chapter 4 (Internal Revenue Code ("IRC") Sections 1471-1474), commonly referred to as the Foreign Account Tax Compliance Act ("FATCA") and Chapter 3 (IRC Sections 1441-1461). The proposed regulations eliminate the withholding on payments of gross proceeds and certain insurance payments, defer withholding on foreign passthrough payments, provided guidance concerning certain due diligence requirements of withholding agents, include clarification of the concept of "investment entity in the context of determining whether an entity is a "financial institution" and modification of nonqualified intermediaries reporting of amounts withheld. The proposed regulations may be relied upon until final regulations are issued except for the revisions relating to credits and refunds of withheld taxes, which may not be relied upon until the IRS Forms 1042 and 1042-S are updated for the 2019 calendar year.

Pension/Retirement

IRS Announces Extension of Transition Period for Guidance on Reporting and Withholding for Escheated IRAs

The IRS published Notice 2018-90 to further extend the withholding and reporting transition relief with respect to payments from individual retirement accounts ("IRA"s) to State unclaimed property funds described in IRS Revenue Ruling 2018-17. IRS Revenue Ruling 2018-17 addressed federal income tax withholding and reporting relating to payment of an individual's interest in an IRA to a State unclaimed property fund, as required by State law. Under the facts presented in IRS Revenue Ruling 2018-17, payments from an IRA to a State unclaimed property fund are subject to federal income tax withholding and reporting. However, under IRS Revenue Ruling, 2018-17 included the following transition relief: "A person will not be treated as failing to comply with the withholding and reporting requirements described in this revenue ruling with respect to payments made before the earlier of January 1, 2019, or the date it becomes reasonably practicable for the person to comply with those requirements." The transition relief in IRS Revenue ruling 2018-17 is further extended with IRS Notice 2018-90 so that a person will not be treated as failing to comply with the withholding and reporting requirements described in IRS Revenue Ruling 2018-17 with respect to payments made before the earlier of January 1, 2020, or the date it becomes reasonably practicable for the person to comply with those requirements.

OTHER

Brokerage Firm Pays $8.9 Million Penalty to Settle Charges Related to Undisclosed Conflict of Interest

In August 2018 Merrill Lynch Pierce Fenner & Smith ("ML") agreed to pay approximately $8.9 million to settle charges related to failing to disclose to investors a conflict of interest in connection with the evaluation of third party products offered to ML clients. In December 2012, a unit of ML's Global Wealth & Retirement Solutions recommended terminating certain products offered by a U.S. subsidiary of a foreign bank. Approximately 1,500 clients had invested about $575 million in these accounts. ML placed a hold on allocating new investments into the products while ML's Governance Committee considered a vote to terminate the products. Staff from the third-party bank learned of the vote and appealed to the Governance Committee to not terminate the products in light of their "broader" business relationship. The Governance Committee delayed the vote and ultimately reinstated investments into these products. The SEC alleged that ML's failure to disclose its other business dealings with such third-party banks to its clients breached ML's fiduciary responsibilities to its clients. The amount of the settlement is based on the roughly $4.03 million ML earned from clients invested in the products during the year long period when the Governance Committee deliberated termination of the products. The SEC order noted that the third-party bank products performed similar to or better than the replacement products that were being recommended by ML.

OCIE Electronic Messaging Risk Alert

The SEC Office of Compliance Inspections and Examinations ("OCIE") staff conducted a limited scope examination initiative and it noticed an increasing use of various types of electronic messaging by adviser personnel for business-related communications. The Risk Alert, issued December 2018 by the OCIE, reminded registered investment adviser firms of their obligations related to the use of electronic messaging.

The OCIE staff referenced a few key investment adviser regulations which remain relevant regardless of the type of electronic messaging being utilized.

Advisers Act Rule 204-2 (Books and Records Rule) requires advisers to make and keep certain books and records relating to their investment advisory business, including typical accounting and other business records as required by the Commission. In particular, Rule 204-2(a)(7) requires adviser firms to make and keep "originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, (iii) the placing or execution of any order to purchase or sell any security, or (iv) the performance or rate of return of any or all managed accounts or securities recommendations."

Advisers Act Rule 206(4)-7 (the Compliance Rule) "requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act

and rules thereunder." Furthermore, the OCIE staff notes, "The Compliance Rule also requires an adviser to review, no less frequently than annually, the adequacy of the adviser's compliance policies and procedures and the effectiveness of their implementation."

Additionally, Rule 204-2(a)(11) "requires advisers to make and keep a copy of each notice, written business communications conveyed electronically using, for example, text/SMS messaging, instant messaging, personal email, and personal or private messaging. The OCIE included communications when conducted on the adviser's systems or third-party applications ("apps") or platforms or sent using the adviser's computers, mobile devices issued by advisory firms, or personally owned computers or mobile devices used by the adviser's personnel for the adviser's business."

During the examination initiative, the OCIE staff observed a range of practices with respect to electronic communications, including advisers that did not conduct any testing or monitoring to ensure compliance with firm policies and procedures. The staff observed and identified the following examples of practices that the staff believes may assist advisers in meeting their record retention obligations under the Books and Records Rule and their implementation and design of policies and procedures under the Compliance Rule:

Among other things, the OCIE recommends that advisers:

- Only permit forms of electronic communication that it believes can be used in compliance with all books and records requirements, including retention of records.
- Prohibit use of applications and technologies that can be easily misused by employees to send messages or communicate anonymously.
- Require employees that receive business messages in a form not permitted by the firm to transfer such message to an electronic system that is in compliance with SEC books and records requirements.
- Where advisers permit the use of social media, personal email accounts and personal websites for business purposes, adopt and implement procedures to monitor, review and retain such communications.
- Have training for employees regarding prohibitions and limitations on electronic messaging and use of applications and requiring supervision where social media, personal email and personal website use is authorized.
- Have control over devices including requiring employees to obtain permission to access firm email servers or other business software from personally owned devices; loading certain security applications or other necessary software on all company-owned or personally owned devices prior to being used for business communication; requiring all employees only access their company email and other applications on virtual private networks (VPNs).

The OCIE encourages advisers to review their risks, practices, policies, and procedures regarding electronic messaging and to consider any improvements to their compliance programs that would help them comply with their regulatory requirements. OCIE also encourages advisers to stay abreast of evolving technology and how they are meeting their regulatory requirements while utilizing new technology.

Voya Fined $1M for Customer Data Intrusions

In September 2018, the SEC fined Voya Financial Advisors, Inc. ("Voya") for violations of the Identity Theft Red Flags Rule and Regulation S-P Safeguards Rule in connection with its failure to establish adequate policies and procedures to protect against cyber intrusion. The fine relates to Voya's failure to prevent unauthorized access to three web portal accounts by intruders impersonating independent representatives during a six-day period in April 2016. The intruders accessed the accounts by contacting Voya's technical support to request a reset of three independent representatives' passwords for the web portal used by the representatives to access Voya customer information. In two instances, the intruders called from numbers previously identified as being associated with fraudulent activity. By calling technical support, the intruders were able to circumvent the multi-factor authentication required to access accounts. The intruders were ultimately able to use the VFA portal access to gain access to personal identifiable information ("PII") of at least 5,600 Voya customers and account documents containing PII of at least one Voya customer.

The SEC alleged that several deficiencies in Voya's data security practices contributed to the intrusions, including:

- Failure to train staff to recognize suspicious phone numbers.
- Failure to confirm the identity of callers seeking to reset web portal passwords.
- Failure to alert customers when portal profiles were modified, or passwords were changed.

In addition, although Voya took steps to respond to the first of the three intrusions, deficient cybersecurity controls and a flawed understanding of the operation of the portal allowed the two subsequent intrusions. Despite the intrusions, no unauthorized transfers of client funds occurred.

The SEC noted that most of the cybersecurity controls for Voya had been outsourced to its parent company whose policies and procedures were not reasonably designed to apply to Voya's independent representative operations. It further asserted that Voya failed to review and update its cybersecurity practices in response to changing risks or provide adequate training to its employees. The Voya case is a reminder to financial firms that cybersecurity policies should be reasonably designed to the unique characteristics and processes of each business unit and that firms should not employ a one-size-fits-all approach.