Industry Trends – February 2017

Industry Statistics – Mutual Funds

Fund Category	Net Assets (in billions) Dec-16	Net Assets (in billions) Sept-16	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	$8,577.1	$8,542.2	0.4%	$34.9	($100.8)	$135.7
Hybrid	$1,388.7	$1,400.2	(0.8%)	($11.5)	($25.0)	$13.5
Taxable Bond	$3,035.6	$3,070.7	(1.1%)	($35.1)	$10.3	($45.4)
Municipal Bond	$613.7	$664.7	(7.7%)	($51.0)	($27.1)	($23.9)
Money Market	$2,728.7	$2,672.3	2.1%	$56.4	$52.4	$4.0
Total	$16,343.8	$16,350.1	(0.0%)	($6.3)	($90.2)	$83.9

- **Stock** funds assets rose a modest $34.9 billion. For the quarter ended December 31, 2016, market appreciation was $135.7 billion compared to an appreciation of $431.4 billion for the quarter ending September 30, 2016. The net assets for stock funds increased from $8,542.2 billion as of the end of September 2016 to $8,577.1 billion at the end of the year.

- **Hybrid** fund assets decreased from $1,400.2 billion as of September 30, 2016 to $1,388.7 billion as of December 31, 2016. This compares to an increase of $25.4 billion in the third quarter of 2016. The decrease was the result of market appreciation of $13.5 billion and net outflows of $25 billion.

- **Bond** funds had net outflows of $16.8 billion for the quarter ended December 31, 2016, compared to the previous quarter inflows of $65.9 billion. Assets for all bond funds decreased $86.1 billion for the quarter ended December 31, 2016 which included, market depreciation of $69.3 billion.

- **Money Market** funds had net inflows of $52.4 billion for the three months ended December 31, 2016, compared to the previous quarter outflows of $30.9 billion. Money market fund net assets, over the three month period increased from $2,672.3 billion as of September 30, 2016 to $2,728.7 billion as of December 31, 2016.

Source: Investment Company Institute website

REGULATORY UPDATE

SEC Issues Guidance on Fund Fee Structure Disclosures

The SEC issued a Guidance Update on December 15, 2016 articulating its views on disclosure issues and procedural requirements that are challenging mutual fund companies that are responding to intermediaries' requests relating to share classes. Intermediaries are making such requests in response to the DOL Fiduciary Rule (the "Rule").

The requests from intermediaries create a number of issues for fund companies, not the least of which is the potential for intermediary-specific disclosures in fund prospectuses and/or statements of additional information ("SAI") regarding variation in sales loads as well as the establishment of new share classes. The Guidance Update recognizes that funds are considering new variations to sales loads for investors that purchase fund shares through a specific intermediary or group of intermediaries in response to requests from intermediaries. According to Rule 22d-1 of the Investment Company Act of 1940, as amended ("1940 Act") and item 12(a)(2) of Form N-1A, variations (or eliminations) of sales loads are allowed if they are specifically disclosed in a fund's prospectus and uniformly applied to certain investors or transactions. The Guidance Update clarifies that the SEC views intermediary-specific variations as permissible if the variations are disclosed in the prospectus and uniformly administered.

The Guidance Update indicates that a fund's prospectus should specifically identify any intermediary to which a specific sales variation applies. In response to industry concerns about lengthy and potentially confusing prospectus disclosure regarding sales load variations, the Guidance Update states that the SEC will allow the use of an appendix to the statutory prospectus to include the disclosure of the sales load variations.

Accordingly, such appendix must:

- Prominently state in the appropriate portion of the prospectus, that different intermediaries may impose different sales loads that are further described in an appendix;
- Include a cross-reference to the appendix in the narrative introduction to the fee table; and
- Specifically identify, within the appendix, the appropriate intermediary by name and include enough information for an investor to determine which variation applies to his/her investment.

The Guidance Update further provides that the appendix can be a stand-alone document if the fund:

- Incorporates, by reference, the appendix and files it with the prospectus;
- States on the front cover of the prospectus that the appendix is part of, and incorporated in, the prospectus;
- States on the outside back cover of the prospectus that information about the different sales load variations is provided in a separate document that is incorporated by reference into the prospectus;
- Delivers the appendix with the prospectus; and
- Posts the appendix on its website (if the fund uses a summary prospectus).

The Guidance Update states that funds must update their prospectuses or appendices on an ongoing basis to reflect new or modified sales load variations.

To add disclosure about sales load variations, the Guidance Update states that a fund must file an amendment under Rule 485(a) of the Securities Act of 1933, as amended ("Securities Act"). However, the Guidance Update does not indicate whether a fund that has already incorporated sales load variation disclosure into its registration statement by way of the Rule 485(a) process could include additional sales load disclosure without the need for an additional Rule 485(a) filing.

The SEC suggests that registrants seek selective review of a filing containing disclosure that is not "substantially different" from previous disclosures made by the fund or fund family, including when a fund is the first in the fund family to implement the new share class or sales load variation. As an alternative, the SEC indicates that if a registrant is making "substantially identical" changes to multiple funds, the registrant may request relief under Rule 485(b)(1)(vii) of the Securities Act (template filing relief). The Guidance Update provides the procedural requirements for selective review requests and template filing relief, including the specific statements and other information that is required in the cover letters for the template filing.

FINRA Approves FINRA Communications with Public Rules

The Financial Industry Regulatory Authority ("FINRA") recently adopted amendments to certain aspects of the FINRA rules governing member firms' communications with the public. The amendments revised certain requirements of FINRA Rules 2210 (Communications with the Public), 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings) and 2214 (Requirements for the Use of Investment Analysis Tools). The rules were effective 1/9/2017. See highlights below.

Rule 2210 - Communications Generally Exempt from Filing

The following communications have been added to the list of communications that are generally exempt from FINRA filing requirements. Other communications may be excluded from filing.

- **Investment Company Shareholder Reports:** The amended rule excludes from the filing requirements the management's discussion of fund performance ("shareholder letter") portion of the annual or semi-annual reports that have been filed with the SEC.
- **Generic Investment Company Communications:** The amended rule no longer requires firms to file generic investment company retail communications. An example of such a generic communication is a retail communication that describes different mutual fund types (*e.g.*, a description of "balanced mutual funds") but does not discuss the benefits of a specific fund or fund family. This type of material typically is intended to educate the public about investment companies in general or the types of products that a firm offers.
- **Filing Exclusion for Templates:** The amended rule expands the template filing exclusion to allow firms to update templates without having to refile the template with FINRA. The expanded template exclusion now includes statistical and data updates, updated non-predictive narrative descriptions of market events during the period covered by the communication, factual descriptions of portfolio changes, as well as updated information that comes from a registered investment company's regulatory documents filed with the SEC.

Rule 2210 - Backup Material for Investment Company Performance Rankings and Comparisons: The amended Rule 2210 eliminates the requirement to file ranking and comparison backup material with FINRA and instead requires firms to maintain back-up materials as part of their records.

Rule 2213 - Bond Mutual Fund Volatility Ratings: Rule 2213 permits firms to use third party bond volatility ratings in retail communications involving specific registered investment companies. Firms are no longer required to accompany or precede a retail communication that includes a bond fund volatility rating with a prospectus for the fund. Firms also may file these communications within 10 business days of first use rather than prior to use.

Rule 2214 - Investment Analysis Tools: Investment analysis tools are interactive technological tools that produce simulations and statistical analyses that present the likelihood of various investment outcomes if particular investments are made or particular investment strategies or styles are undertaken. Amended Rule 2214 eliminates the filing requirements for investment analysis tool report templates and retail communications concerning such tools and instead requires firms to provide FINRA staff with access to investment analysis tools upon request.

For your reference, here is a link to Regulatory Notice 16-41 which outlines the changes to FINRA rule 2210 that were effective 1/9/17:

http://finra.complinet.com/net_file_store/new_rulebooks/r/e/Regulatory-Notice-16-41.pdf

SEC Sues Audit Engagement Partner for Failure to Scrutinize Misconduct

On October 31, 2016, the SEC instituted enforcement proceedings against the engagement partner of a former auditor for the Burrill Life Sciences Capital Fund III (the “Fund”) asserting that the partner failed to scrutinize almost $18 million in withdrawals from the Fund under the guise of “advanced management fees” which greatly exceeded any potential future management fees that the Fund might owe.

The SEC also alleged that the partner failed to ascertain whether the Fund’s adviser was properly authorized to take the money and that the partner removed relevant financial statement disclosure of the withdrawals after objections from the adviser. The principal of the investment adviser to the Fund settled an SEC case earlier in 2016 that found he used the money to maintain his other businesses and to pay for family vacations and other personal expenses. The press release announcing the action stressed that the SEC views auditors as performing “a critical check on fraudulent conduct, especially when related party transactions are involved.” The audit firm has stated that it intends to contest the charges.

SEC Proposes Shortening Settlement Cycle

The SEC has proposed amendments to Rule 15c6-1(a) under the Securities Exchange Act to change the settlement cycle from three business days after trade date (“T+3”) to two business days after trade date (“T+2”) for most broker-dealer transactions. The SEC identified numerous benefits for shortening the settlement cycle and cites the change for certain investments going into effect September 2017. The decreased settlement cycle would lower the amount of unsettled trades, correspondingly reducing credit, market, and liquidity risk exposure for shareholders, helping stabilize the U.S. markets. The SEC proposes a September 2017 compliance date for the transition to a T+2 settlement cycle.

SEC Inquires About Valuation Process for Private Tech Companies

In December 2016, the SEC sent letters to Fidelity and T. Rowe Price, among other firms, seeking information about how the firms value holdings in private tech companies. Key issues addressed in the letter included the use of comparisons of private tech companies to publicly traded companies to calculate a startup’s value and the lack of uniform valuation methods across fund companies. Due to the variety of valuation processes employed by firms different money managers may have significantly different valuations for the same companies. Also contributing to the valuation differences is the fact that access to information from private companies may vary from manager to manager. The process for valuing private tech companies had been the subject of increasing attention from the SEC due to concerns over the valuation of so-called “unicorns” – startups valued at more than $1 billion such as Uber and Airbnb – which may grow to represent a relatively large portion of a fund’s holdings. In addition to the process-related concerns regarding valuation, the SEC has been increasingly focused on the impact of liquidity on valuation of private investments.

DOL Fiduciary Rule Update

As of this writing (less than one week post-inauguration), the first compliance date for the DOL Fiduciary Rule (the “Rule”) is still slated for April 10, 2017. However, there are reports that the Trump administration is planning a six-month delay.

With the April compliance date in mind, several mutual funds have registered new T shares, most of which have a maximum sales charge of 2.50%. The new share class and uniform 2.50% load is the result of broker-dealers and mutual funds identifying a front-end load share class that is in compliance with the Rule. Major trading platforms have indicated a preference for a flat sales charge resulting in many of the larger fund companies making filings with the SEC to add T shares to their product lines with the maximum 2.50% load structure. The recent interest in the uniform load structure is one of the ways the mutual fund industry is reacting to industry pressures as a result of the Rule.

A major question facing the industry is how to serve individual retirement account holders on a commission basis. Some broker-dealers have altogether disallowed commissions in such retirement accounts while others will allow advisers to continue as they have been, but adding controls to ensure that advisers have an executed best interest contract (“BIC”) with clients before proceeding. The move away from commissions is consistent with the post-financial crisis push toward fee-based accounts.

In a recent no-action letter, the SEC reported it will permit brokers that sell “clean” shares of mutual funds in retail accounts to determine their own commission structure. (A clean share does not include loads, sub-transfer agency fees or 12b-1 fees.) Up until this point, commissions paid to brokers for mutual fund sales have come from load structures and other components of the fund’s expenses established by fund providers and their boards. Consequently, commissions can vary between fund providers and funds within the same family. The SEC indicated that Section 22(d) of the Investment Company Act of 1940, as amended (the “1940 Act”) does not apply to a broker when the broker acts as agent on behalf of its customers and charges its customers commissions for affecting transactions in clean shares. The SEC further stated that its position does not depend on whether clean shares are sold in a retirement account or nonretirement account. This approach differs from the strategy of the addition of the T shares as described above. It is too early to know whether distributors will prefer one approach over the other.

In early January, the DOL issued two additional sets of FAQs, following the first FAQ issued in October. One set of FAQs related mainly to advisors, covering the various provisions of the Rule that delineate between fiduciary and non-fiduciary communications. The other set of FAQs issued at the same time focused on questions raised for workers and retirement investors.

SEC Issues Administrative Order for NAV Error

The SEC has issued an administrative order to Calvert Investment Management, Inc. ("Calvert"), the adviser to the Calvert Funds (the "Funds"), for improperly handling the corrective actions necessary stemming from an inaccurate valuation of securities for over a three year period. While Calvert made an attempt to remedy the situation by paying $27 million to the Funds and shareholders, the payment amount was an estimate and details surrounding the corrective actions, which were outside the Funds' NAV error correction procedures, were not disclosed to the shareholders. Also, the SEC found the payment compensated shareholders differently whether they were directly held or through an intermediary. Furthermore, in a separate violation, the SEC found that Calvert did not report a prohibited transaction to the Funds' Board of Trustees in a timely fashion in order to meet the requirement under Rule 17a-7.

Update for Commodity Pool Operators ("CPOs) and Commodity Trading Advisors ("CTAs")

The National Futures Association ("NFA") requires a liquidation statement that complies with Regulation 4.22(c)(7) for a fund that has liquidated. The Commodity Futures Trading Commission's staff ("CFTC") continues to review how registered fund CPOs should satisfy the requirement and may issue guidance. Until further guidance is issued the NFA is not waiving the requirement and is generally requesting audited financial statements.

The NFA has issued a Notice to Members ("NTM") reminding CPO and CTA members that they must annually reaffirm their notice of exemption within 60 days of the calendar year end. The notice is required for any member that rely on exemption from CPO registration under CFTC Regulation 4.5 and other regulations.

The CFTC recently adopted final rules on aggregation for purposes of position limits. The final rules require all positions in accounts for which a person control trading or holds 10% or greater ownership to be aggregated. In addition, any person that holds or controls the trading positions in more than one account or pool with substantially identical trading strategies must aggregate all positions held and trading. Aggregation is required for an investment advisor to registered funds even if those funds have different investment strategies.

Court Rules No Attorney-Client Privilege for Independent Trustees

On November 21, 2016, the U.S. District for the Western District of Washington issued an order in an excessive fee case granting a motion to compel certain independent trustees of the PIMCO Total Return Fund (the "Fund") to produce documents that had been redacted or withheld under the attorney-client privilege. The court determined that the "fiduciary exception" to the attorney-client privilege applied to communications between the trustees and their counsel. In making its determination, the court found that the trustees owed a fiduciary duty to the Fund's shareholders and that the trustees' communications with counsel included legal advice for managing the Fund, not personal advice to the trustees. The court rejected the argument that the fiduciary exception had never been applied in mutual fund litigation and that it would serve to chill communications between independent trustees and their counsel to the detriment of shareholders. Under the ruling, attorney-client privilege would apply only when "the trustee shows that he or she obtained legal advice for his or her personal protection or independent personal purpose."

Government Accountability Office Issues Report on Proxy Advisory Firms

The Government Accountability Office ("GAO") recently issued a report on the role that proxy advisory firms play in corporate governance and proxy voting. The GAO noted that in preparation of the report, its staff interviewed various interested parties and reviewed each of the five proxy advisory firms' policies and procedures as well as additional industry literature. The GAO also reviewed the SEC's policies on proxy voting as well as its proxy voting examination results.

The GAO did not present any recommendations in its report, but rather shared the findings from its review. First, it discussed the perceived influence that proxy advisory firms have in the industry. It noted the increased industry demand for proxy advisory firms and shared that interested parties had varied opinions on the extent of the firms' inclusion. Next, the GAO shared its observations of the firms' voting policies. It noted that most firms' policies incorporated institutional investor and corporate issuer input as well as results from discussions with other interested parties within the industry. The GAO noted that most market participants found that proxy advisory firms' stance on corporate governance "best practices" were stricter than other industry standards. Finally, the report also addressed the SEC's past and current oversight activities, noting that as of August 2016, the SEC had completed just under half of its targeted proxy advisory examination sweep.

Financial Reporting Modernization and Liquidity Rules Update

As reported last quarter, the SEC adopted rules to modernize and expand the reporting and disclosure of information by registered investment companies and to enhance liquidity risk management by open-end funds. With these rules, investment companies will be required to file a new monthly portfolio reporting form (N-PORT) and a new annual report (N-CEN). These reports contain a number of new data fields previously not required, or not available in typical fund accounting data. The industry is working with third-party vendors and others to determine the appropriate source for this data. The Rule becomes effective for large funds in June of 2018.

The Liquidity Risk Management Rules also requires the classification of the liquidity of portfolio investments and the creation of a highly liquid investment minimum. The classification of liquidity of portfolio securities is also tied to the 15% limit on illiquid investments and may have an impact on some fund's investment strategies. Several vendors are developing tools that are anticipated to assist funds in classifying investments and in determining overall portfolio liquidity.

Service providers are in the process of analyzing the new Rules, data service providers, and reporting systems to determine how to best provide this service to funds.

Division of Investment Management Staff Guidance on Investment Adviser Reliance on Predecessor Registration

The Division of Investment Management Staff ("IM Staff") recently released guidance to help clarify when an investment adviser may be able to rely on predecessor registration. In additional to identifying scenarios when predecessor registration may be applicable, the IM Staff also discussed the methods by which a successor investment advisor can effectuate registration under these special provisions.

The SEC has previously stated that the purpose behind reliance on predecessor registration is to enable a successor registrant to operate without an interruption of business when the transfer of business between the entities is legitimate. A successor investment adviser may utilize one of two methods of predecessor registration: "succession by application" or "succession by amendment."

A successor investment adviser may utilize "succession by application" when the successor entity is unregistered and is acquiring substantially all the assets and liabilities of a SEC-registered investment adviser. To rely on this method, the acquired adviser must have ceased advisory activities and the successor adviser must apply for registration within thirty days of the succession event. If these criteria are met, the guidance states that the successor adviser may rely on the predecessor's registration until the SEC declares the successor's registration application effective.

Alternatively, a successor investment adviser may utilize "succession by amendment" when the successor entity is a new investment adviser solely resulting from a change in business status of a related organization. Additionally, there can be no practical change in control or management of the organization at issue. If these criteria are met, the successor adviser may rely on the predecessor registration if it files an amended Form ADV within 30 days of the organizational change.

The guidance states that is important for each adviser to strictly adhere to the statutory timeframes of each method of predecessor registration, so as to not risk conducting an investment advisory business without being registered.

ICI Requests Additional Information Regarding Application of Regulated Investment Company Deficiency Dividend Procedures

The Investment Company Institute ("ICI") recently submitted a letter to the IRS and U.S. Department of the Treasury ("Treasury") requesting application of the dividend deficiency procedures under Section 860 of the Internal Revenue Code for regulated investment companies ("RIC"s) when a RIC becomes subject to the new partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 as a result of the RICs investments. Specifically, the ICI requested that the dividend deficiency procedures be made available to RICs and for clarification on application of the rules.

Due to the various distribution and excise tax provisions applicable to RICs, RICs generally distribute all of their income and gains annually. If that isn't done during a taxable year or under a "spillback dividend," the RIC can pay a deficiency dividend under Section 860 and also pay interest charges. Because the partnerships in which RICs invest are subject to new partnership rules, adjustments resulting from audits of the partnerships could affect a RICs distribution requirements for a prior year or years. The ICI requested further specificity on how the dividend deficiency rules would operate and:

- Specify the "determination date" for purposes of Section 860 when a partnership is audited;
- Confirm that a RIC that pays a deficiency dividend will be charged interest only under Section 860 (and not any other section(s));
- Provide that a RIC will be subject to penalties only to the extent that it has any tax liability under Section 6226 resulting from its share of an adjustment under that provision; and
- Permit tiered partnerships to use the alternative audit procedures under Section 6226.

ACCOUNTING UPDATE

FASB Proposes Update to Amortization Period for Callable Debt Securities

The Financial Accounting Standards Board ("FASB") released an exposure draft that would shorten the amortization period for callable debt securities. The proposed changes would require the premium to be amortized to the earliest call date. The proposed changes do not suggest a change to securities purchased at a discount.

If a security amortizes premium over the life of the instrument then, if called before maturity, the unamortized premium is recognized as a loss. FASB also determined that amortization practices are not consistent for callable debt.

The ICI recently filed a comment letter supporting the change but suggested that yield-to-worst is used instead of the first call date.

A fund would apply the proposed amendment through a cumulative effect adjustment to undistributed income as-of the beginning of the first reporting period the change is effective. No effective date was included in the proposal and the ICI suggested that the effective date be no sooner than one year after the standards are updated.

TAX UPDATE

Regulatory

Treasury International Capital ("TIC") Form SCH ("TIC SCH") Survey of U.S. Ownership of Foreign Securities

The Department of the U.S. Treasury, with the assistance of the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York ("FRBNY"), is conducting a mandatory quinquennial survey of the ownership of foreign securities, including selected money market instruments, by U.S. residents as of December 31, 2016. The data will be collected by the FRBNY acting as fiscal agent for the Department of the Treasury. The data collected will be used by the U.S. Government in the computation of the U.S. balance of payments accounts and the U.S. international investment position, and in the formulation of international economic and financial policies. This report also is part of the Coordinated Portfolio Investment Survey ("CPIS"), an internationally coordinated effort under the auspices of the IMF, to improve the statistics on the holdings of foreign securities by major investing countries.

A benchmark survey Report of U.S. Ownership of Foreign Securities, Including Selected Money Market Instruments (Form SHC) of all significant U.S. -resident custodians and end-investors will continue to be held approximately every five years. The next full Benchmark survey will be as of December 31, 2016.

The determination of who must report on the benchmark survey reports (Form SHC) will be based upon the data submitted during the previous Benchmark survey and Aggregate Holdings of Long-Term Securities by U.S. and Foreign Residents (TIC SLT) report as of December of the preceding year. Designated U.S.-resident custodian and end-investors (including fund managers) will be required to filed detailed foreign security data on Schedule 2 and data on foreign securities entrusted to U.S.-resident custodians on Schedule 3, i.e., they will be required to file in the same manner as they did on the previous Benchmark survey.

All U.S. resident custodians and end-investors with holdings of foreign portfolio securities above the reporting thresholds must report. In addition, all U.S.-resident custodians and end-investors that are notified by the Federal Reserve Bank of New York that they are required to file must report.

Custodians are all organizations that hold securities in safekeeping for other organizations. End-investors are U.S.-resident organizations that invest in foreign securities for their own portfolios or invest on behalf of others, such as investment managers/fund sponsors. This includes securities that are held-for-trading, available-for-sale, or held-to-maturity. U.S.-

resident end-investors include, but are not limited to: financial and non-financial organizations, managers of private and public pension funds, managers/sponsors of funds (including money market funds), country funds, unit-investment funds, exchange-traded funds, collective-investment trusts, hedge funds or any other similarly polled, commingled funds. Also manager/sponsors of private equity companies, venture capital companies, hedge funds and other private investment vehicles, insurance companies, foundations, institutions of higher learning (e.g., university endowments), trusts and estates, funds and similar entities that own shares or units of, or other portfolio equity interests in , a foreign related or non-related entity.

Reports should include all reportable securities held or managed by all U.S.-resident parts of the organization, including all U.S.-resident branches, offices, and subsidiaries.

The Report of U.S. Ownership of Foreign Securities, Including Selected Money Market Instruments (SHC) consists of Schedules 1-3. Schedule 1, titled Reporter Contact Identification and Summary of Financial Information, must be filed by all entities that 1) receive a copy of the SHC forms and instructions from the Federal Reserve Bank of New York, or 2) are notified by the Federal Reserve Bank of New York that they are required to file the SHC report.

Schedule 1 requests information that identifies the reporter and provides contact information, indicates the reporting status, and summarizes the data, if any, reported on Schedule 2 and/or Schedule 3. Schedule 2, titled Details of Securities, reports detailed information on foreign securities owned by U.S.-resident investors (1) that the reporter safe-keeps for itself or for its U.S.-resident clients or (2) for which the reporter directly employs foreign-resident sub-custodians or (3) that are instruments of the type that there is no U.S. custodian to manage the safekeeping of those securities and Schedule 3 titled Custodians Used, reports summary amount for all foreign securities entrusted to the safekeeping of a U.S.-resident custodian.

If you have been notified of a reporting responsibility by the Federal Reserve Bank of New York, there is no exemption level for Schedule 1. You must complete the reporter identification, the contact and certification information parts of Schedule 1. However, items requesting aggregate data on foreign securities on Schedule 1 should be left blank if you are not required to report data no Schedule 2 or Schedule 3. SHC reporters are exempt from reporting on Schedule 2 if the total fair value of foreign securities whose safekeeping they manage for themselves and for other U.S. residents or whose safekeeping the reporter has entrusted directly to foreign-resident custodians is less than $200 million (aggregated over all accounts). SHC reporters are exempt from reporting on a Schedule 3 holdings that are entrusted to an unaffiliated U.S.-resident custodian, if the total fair value of the foreign securities entrusted to that U.S-resident custodian by the U.S. parts of the reporter's organization and its U.S.-resident clients whom the reporter represents as end-investor – aggregated over all accounts – is less than $200 million.

Report data as of the last business day of December (i.e., December 30, 2016). Data should be submitted to the Federal Reserve Bank of New York no later than the first Friday of March (i.e., March 3, 2017).

IRS Notice 2016-76 Dividend Equivalent Guidance under IRC Section 871(m)

The U.S. Treasury Department ("Treasury") and IRS issued Notice 2016-76 on December 2, 2016 that provides taxpayers with guidance for complying with final and temporary regulations under internal revenue code ("IRC") section 871(m), 1441, 1461 and 1473 (collectively, referred to as the section 871(m) regulations) in 2017 and 2018. Because amendments to the section 871(m) regulations are expected, the Treasury and the IRS have determined that it is appropriate to phase in the application of certain rules in the section 871(m) regulations to facilitate the implementation of those regulations.

Section 871(m) was added to the IRC in 2010 as part of the Hiring Incentives to Restore Employment Act (the HIRE Act). Added to prevent non-U.S persons from avoiding U.S. dividend withholding taxes, it subjects certain "dividend equivalent" payments to U.S. withholding tax by treating those payments as dividends from U.S. sources. Accordingly, a withholding agent generally is required to deduct and withhold a tax equal to 30 percent on any dividend equivalent payment made to a foreign person unless an exception from, or lower rate of, withholding applies pursuant to the IRC or regulations, or an applicable income tax treaty. It is generally effective for dividend equivalent payments made on or after September 14, 2010, IRC section 871 applies to U.S. equity-linked swap agreements in only limited circumstances through December 31, 2016. New regulations released in September 2015 that were to take effect on January 1, 2017, generally would apply to U.S. equity-linked swaps and other derivative instruments that have a "delta" (generally, the ration of a change in value of the derivative position to a change in value of the referenced security) of at least .8 at the time of issuance.

The Treasury and IRS intend to provide a phased-in application of section 871(m) and the 871(m) regulations to U.S. equity-linked swaps and other derivatives that are entered into on or after January 1, 2017.

Notice 2016-76 provides:

For 2017, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations in enforcing the 871(m) regulations for any delta-one transaction;

For 2018, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations in enforcing the section 871(m) regulations for any non-delta-one transaction.

For 2017, withholding agents may rely on a simplified standard for determining whether transactions are combined transactions pursuant to the regulations.

For 2017, withholding agents may remit amounts withheld for dividend equivalent payments quarterly.

For 2017 and following years, a qualified derivatives dealer's ("QDD") section 871(m) amount is to be determined by calculation the net delta exposure of the QDD.

For 2017, the IRS will take into account the extent to which the QDD made a good faith effort to comply with the QDD provisions in the QI agreement when enforcing those provisions.

Prospective QDDs may apply for QDD status on or before March 31, 2017, and if accepted by the IRS, be treated as having QDD status as of January 1, 2017

Before receiving a qualified intermediary employer identification number ("QI-EIN"), QDDs may provide a statement on a Form W-8IMY that the QDD is "awaiting QI-EIN" and withholding agents may rely on this statement, to the extent permitted in this notice.

The section 871(m) regulations will not apply to certain existing exchanged-traded notes specifically identified in this notice until January 1, 2020.

ICI Comment Letter on Proposed Regulations under Sec. 851 on Investments in CFCs and PFICs

The Investment Company Institute ("ICI") submitted a letter, dated December 22, 2016, to the IRS and the U.S. Department of the Treasury ("Treasury"), containing comments on the proposed regulations under internal revenue code ("IRC") section 851, regarding whether investments by regulated investment companies ("RICs") in controlled foreign corporations ("CFCs") and qualified electing funds ("QEFs") qualify as "good income" under IRC section 851(b).

The IRS and Treasury issued proposed regulation that provides guidance relating to the income test and the asset diversification requirements that are used to determine whether a corporation may qualify as a RIC for federal income tax purposes. In general, the proposed regulations would provide that (1) inclusion amounts from a CFC under IRC section 951 (Subpart F Inclusions) or from a QEF under IRC section 1293 will be treated as "dividends" only to the extent that the CFC or QEF has made a distribution out of its earnings and profits and (2) such inclusion amounts will not be treated as "other income" derived with respect to a RIC's business of investing in such stock, securities, or currencies.

The ICI strongly recommends that the IRS and Treasury eliminate from the final regulations the part of the proposed regulations that state that such inclusion amounts will not be treated as "other income" derived with respect to a RIC's business of investing in such stock, securities or currencies. The ICI believes that the inclusion, which would reclassify many inclusions from CFCs and QEF as bad income, is unnecessary, arbitrary, and contrary to legislative intent.

ICI Letter RE Application of New Partnership Audit Rules to RICs

The Investment Company Institute (“ICI”) submitted a letter, dated October 24, 2016, to the IRS and the U.S. Department of the Treasury (Treasury) urging them to clarify the application of the new partnership audit regime, enacted as part of the Bipartisan Budget Act of 2015, to regulated investment companies (“RICs”) that are partners in an audited partnership. Specifically, the ICI agrees with the National Association of Real Estate Investment Trusts (“NAREIT”) that the deficiency dividend procedures under the internal revenue code (“IRC”) section 860 should be available. Like real estate investment trusts (“REITs”), RICs often invest in partnerships and may become subject to the new partnership audit procedures as a partner in a partnership that is subject to audit. The ICI therefore asks that the IRS and Treasury confirm that RICs may use the existing deficiency dividend procedures with respect to their allocable share of the applicable adjustment to partnership income, gain, loss, or deduction, and take any deficiency dividend paid into account in (1) the filing of a return by a RIC in accordance with the new IRC section 6225(c); or (2) the calculation of the RIC's adjustment to tax under the new IRC section 6226(b). The ICI also asked that the government clarify the application of the interest and penalties under the new partnership audit rules and IRC section 860. The ICI also stated that they agree with others who have recommended the ability of an upper-tier partnership to pass through to its partners an adjustment from a lower-tier partner under IRC section 6226. The ICI believes that such a rule satisfies the intent of the new partnership audit rules without unfairly harming lower-tier partners by denying them the benefits of the alternative rules in IRC section 6226.

State

2016 ICI State Tax Survey

The Investment Company Institute ("ICI") has updated their annually released State Tax Survey, and it is available on the ICI's website.

The surveys include:

Survey 1: State Income Taxation of Dividends Paid by a RIC Derived in Whole (or in Part) from Interest on Federal Obligations

Survey 2: State Taxation of State and Local Obligations

Survey 3: State Taxation of Long-Term Capital Gain Distributions Made by RICs to Individual Shareholders

Survey 4: State Taxation of Contributions to and Distributions from Certain Retirement Plans

Survey 5: State Taxation of Qualified Tuition Programs (Section 529 Plans).

OTHER

Whistleblower Rule Compliance

In the fourth quarter of 2016, the SEC's Office of Compliance Inspections ("OCI") reported that it had examined registrants' compliance with key whistleblower provisions arising out of the Dodd-Frank Wall Street Reform and Consumer Protections Act (the "Dodd-Frank Act"). The SEC has recently brought several enforcement actions charging violations of Rule 21F-17 of the SEC's whistleblower regulations. The SEC is examining registered investment advisers and registered broker-dealers; also reviewing compliance manuals, codes of ethics, employment agreements and severance agreements to determine whether provisions in these documents may raise concerns under Rule 21F-17.

Recent enforcement actions have identified certain provisions of confidentiality or other agreements required by employers that violated Rule 21F-17 because they included language that impeded employees from communicating with the SEC concerning possible securities law violations. Some agreements or documents provide that an employee may forfeit all benefits if he or she violates any terms of the agreement (e.g. severance agreements). In its review, the SEC determines whether the documents at issue violate Rule 21F-17 by including provisions that limit the types of information that an employee may convey to the SEC or other regulators and require departing employees to waive their rights to any individual monetary recovery in connection with reporting information to a governmental authority. When examining registrants' compliance with Rule 21-17, the SEC is citing deficiencies and making referrals to the Division of Enforcement when appropriate.

Broker/Dealer Agrees to Fine as a Result of a Hack of a Third-Party Service Provider's Cloud-Based Servers

Recently Lincoln Financial Securities Corporation ("Lincoln") agreed to pay a $650,000 fine to settle charges brought by the Financial Industry Regulatory Authority ("FINRA") for failing to establish adequate procedures to protect confidential customer information stored on its cloud-based systems. FINRA noted that while Lincoln's written supervisory procedures provided some guidance regarding storage of customer data on cloud servers, it was not specific enough to be actionable. Additionally, the allegations were that Lincoln failed to adequately oversee the third-party firm that provided the cloud-based servers. It should be noted that the charges were brought after hackers with foreign Internet Protocol addresses were able to access the servers and the information of approximately 5,400 Lincoln customers.