Industry Trends – November 2017

Industry Statistics – Mutual Funds

Fund Category	Net Assets (in billions) Sept-17	June-17	Percentage Change in Net Assets	Dollar Change in Net Assets (in billions) Total Change	Change Due to Net Cash Flows	Market
Stock	$9,864.9	$9,460.1	4.3%	$404.8	($50.7)	$455.5
Hybrid	$1,489.9	$1,454.4	2.4%	$35.5	($10.0)	$45.5
Taxable Bond	$3,332.0	$3,239.7	2.8%	$92.3	$57.1	$35.2
Municipal Bond	$660.6	$645.2	2.4%	$15.4	$9.9	$5.5
Money Market	$2,747.6	$2,633.4	4.3%	$114.2	$111.7	$2.5
Total	$18,095.0	$17,432.8	3.8%	$662.2	$118.0	$544.2

- **Stock** funds assets had an increase during the quarter of $404.8 billion. For the quarter ended September 30, 2017, market appreciation was $455.5 billion compared to an appreciation of $359.4 billion for the quarter ending June 30, 2017. The net assets for stock funds increased from $9,460.1 billion as of June 30, 2017 to $9,864.9 billion at the end of the third quarter of 2017.

- **Hybrid** fund assets increased from $1,454.4 billion as of June 30, 2017 to $1,489.9 billion as of September 30, 2017. This compares to an increase of $21.4 billion in the second quarter of 2017. The increase was the result of market appreciation of $45.5 billion and net outflows of $10.0 billion.

- **Bond** funds had net inflows of $67.0 billion for the quarter ended September 30, 2017, compared to the previous quarter inflows of $60.5 billion. Assets for all bond funds increased $107.7 billion for the quarter ended September 30, 2017 which included, market appreciation of $40.7 billion.

- **Money Market** funds had net inflows of $111.7 billion for the three months ended September 30, 2017, compared to the previous quarter outflows of $33.6 billion. Money market fund net assets, over the three month period increased from $2,633.4 billion as of June 30, 2017 to $2,747.6 billion as of September 30, 2017.

Source: Investment Company Institute website

REGULATORY UPDATE

Most Frequent Advertising-Rule Compliance Issues Identified in OCIE Examinations

In a Risk Alert issued on September 14, 2017, the SEC Office of Compliance Inspections and Examinations ("OCIE") provided a list of compliance issues relating to Rule 206(4) -1 (the "Advertising Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").

Below are the most frequent deficiencies that the OCIE staff identified in connection with failure to comply with the Advertising Rule:

- *Misleading Performance Results.*
    - Advisers that presented performance results without deducting advisory fees.
    - Adviser advertisements that compared results to a benchmark but did not include disclosures about any significant differences between the adviser's strategy and the benchmark to which it was compared.
    - Adviser advertisements that contained hypothetical and back-tested performance results, but did not explain how these returns were derived and did not include other potentially material information regarding the performance results.
- *Misleading One-on-One Presentations.*
    - Advisers that advertised performance results (gross of fees) in certain one-on-one presentations, but did not include potentially relevant disclosures.
    - Advisers did not disclose that the advertised performance results did not reflect the deduction of advisory fees and that client returns would be reduced by such fees and other expenses.
- *Misleading Claim of Compliance with Voluntary Performance Standards.*
    - Advisers that claimed that their advertised performance results complied with a certain voluntary performance standards (such as GIPS) that did not.
- *Cherry-Picked Profitable Stock Selections.*
    - Advisers that included only profitable stock selections or recommendations in presentations, client newsletters, or on their websites, without meeting the conditions set forth in Subsection (a)(2) of the Advertising Rule.

- *Misleading Selection of Recommendations.*
    - Advisers that disclosed past specific investment recommendations that may have been misleading because they included only certain, and not all, recommendations, in order to illustrate a particular investment strategy, and they did not meet the conditions set forth in Subsection (a)(2) of the Advertising Rule. In addition, they did not satisfy the representations upon which IM staff based certain no-action assurances as provided in the TCW Group SEC Staff No-Action Letter (November 7, 2008) and Franklin No-Action Letter (December 10, 1998).
- *Compliance Policies and Procedures.*

SEC staff observed advisers that did not have, or did not implement, policies and procedures pertaining to the following issues:

- Procedures for reviewing and approving advertising materials prior to use.
- Procedures for determining the parameters for which accounts were included or excluded from composite performance calculations.
- Procedures to confirm the accuracy of performance results.

The Risk Alert also reported on the observations from the 2016 "Touting" examination sweep of advisers. OCIE staff observed a number of issues related to the use of accolades in advertisements including:

- *Misleading Use of Third Party Rankings or Awards.*

SEC OCIE staff observed advisers that published potentially misleading advertisements containing references to awards or rankings conferred by third parties that failed to disclose the material facts about the awards or rankings.

- Advisers advertised accolades that had been obtained by submitting potentially false or misleading information in the applications for such accolades.
- Advisers published marketing materials that referenced stale ranking or evaluation information.
- Advisers published potentially misleading advertisements that did not disclose the relevant selection criteria for the awards or rankings, or who created and conducted the survey and the fact that advisers paid a fee to participate in or distribute the results of the survey.

- *Misleading Use of Professional Designations.*
    - SEC OCIE staff observed advertisements that contained potentially false or misleading references to employee professional designations that have lapsed or that did not explain the minimum qualifications required to attain such designations.
- *Testimonials.*
    - SEC OCIE staff observed advisers that had published statements of clients attesting to their services or otherwise endorsing the adviser that may be prohibited testimonials.

The Risk Alert did not contain any new interpretive positions or policies. Advisers can expect OCIE staff to continue to focus examination resources in the area of marketing.

SEC Imposes Fine on Investment Adviser for Failing to Disclose Revenue-Sharing Arrangement with Broker-Dealer

An investment adviser recently settled charges with the SEC for failing to disclose to its investment advisory clients that it received revenue-sharing payments from a third-party broker-dealer for over a decade. The SEC also noted that as a result of various arrangements, the investment adviser failed to seek best execution for its investment advisor clients. The main revenue-sharing arrangement issue involved the investment adviser's clearing broker sharing revenues from certain mutual funds without disclosing the arrangement to its clients or the SEC. The SEC found that the arrangement created a financial incentive and a conflict of interest. The SEC further found that the investment adviser, which was dually-registered as a broker-dealer, negotiated a reduction in transaction costs without passing along the savings to its clients. The SEC noted that the investment adviser failed to consider whether its clients were still receiving best execution in light of the revenue sharing. The SEC fined the firm over $500,000, encompassing disgorgement, interest, and a $100,000 penalty.

SEC Extends Loan Provision Relief for Purposes of Auditor Independence

On Friday, September 22, the SEC's Division of Investment Management issued a letter extending the period of relief offered to entities in an "investment company complex" relying on audit services performed by public accounting firms whose independence might be compromised. The letter extends relief, which was set to expire in December, from a June 2016 no-action letter addressing auditor independence issues related to a provision in Regulation S-X ("Loan Provision"). The extension makes no changes to the scenarios or representations in

the original no-action letter and provides relief until the effectiveness of any amendments to the Loan Provision designed to address the concerns expressed in that letter.

The SEC's current 2017 Regulatory Flexibility Agenda includes a reference to a rulemaking in this area, and ICI will continue to engage with the SEC and its staff on any such potential rulemaking.

SEC Staff Issues FAQs on New Fund Reporting Rules

On July 18, 2017, the Division of Investment Management issued the first set of frequently asked questions on the new fund reporting rules. The FAQs fell into four broad categories, as follows:

- **Compliance Date and General Filing Obligations**
    - *Form N-PORT*: As discussed in the Adopting Release, larger entities—funds that together with other investment companies in the same group of related investment companies have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund—have a compliance date of June 1, 2018. Smaller entities have a compliance date of June 1, 2019. Funds must file reports on Form N-PORT no later than 30 days after the end of each month. Compliance should be based on reporting period-end date. This means, for example, that funds that are part of larger entities would file their first reports on Form N-PORT, reflecting data as of June 30, 2018, no later than July 30, 2018.
    - *Form N-CEN*: The compliance date for Form N-CEN is June 1, 2018 for all funds. Funds must report on Form N-CEN within 75 days of the fund's fiscal year-end (75 days after the calendar year-end for unit investment trusts). Compliance should be based on reporting period-end date. For example, a fund with a June 30 fiscal year-end should make its first filing for the year ended June 30, 2018 on Form N-CEN by September 13, 2018. A fund with a May 31 fiscal year-end would not need to make its first filing on Form N-CEN until the fiscal year ending May 31, 2019 (with such filing being made within 75 days of that date) because May 31, 2018 is prior to Form N-CEN's compliance date.
    - Once a fund begins filing reports on Form N-PORT, it will no longer be required to file reports on Form N-Q. Moreover, when a fund ceases filing reports on Form N-Q, its certification on Form N-CSR must cover any change in the registrant's internal control over financial reporting that occurred during the most recent fiscal half-year, rather than the registrant's most recent fiscal quarter as currently required.

- For example, the staff believes that a fund that is part of a larger entity, for which the Form N-PORT compliance date is June 1, 2018, would file the Regulation S-X compliant portfolio schedule as Exhibit F to Form N-PORT relating to the 3rd and 9th fiscal months beginning June 1, 2018, in lieu of Form N-Q, even though Form N-Q will not be rescinded until August 1, 2019.

- **N-PORT**
  - *How will Form N-PORT Part F attachments be added to filings made on Form N-PORT?*
    - Funds must file reports on Form N-PORT up to 30 days after the end of each month, but may file Part F attachments up to 60 days after the end of the reporting period. As will be detailed more fully in the EDGAR Filing Manual, Part F attachments and amendments to those attachments should be filed as EDGAR submission types "NPORT-EX" and "NPORT-EX/A," respectively. Funds should also provide the accession number of the related report on Form N-PORT, so that the Part F submission can be attached to that report by the Commission. Adding the Part F attachment in this manner will not cause the original report on Form N-PORT to be marked as amended in EDGAR. Additional details and instructions will be provided in the EDGAR filing manual.
  - *Will reports filed for the month ended December 31, 2018 be the first Form N-PORT filings made public?*
    - Yes. The SEC states in the Adopting Release that it has "determined to maintain as nonpublic all reports filed on Form N-PORT for the first six months following June 1, 2018." This means that reports filed on Form N-PORT for the months ended June 30 through November 30, 2018 will be non-public, and that reports filed for the months ended December 31, 2018 and later will be made public (but only those filings for the third month of each fund's fiscal quarter). Commission staff notes, however, that even during the six-month non-public filing period, portfolio holdings information filed as exhibits to Form N-PORT (*i.e.,* Form N-PORT Part F attachments) for the first and third quarters of the fund's fiscal year will be made public.

- *Form N-PORT requires funds to file reports within 30 days of month-end. How should funds report values for holdings where no market value is available at that point for month-end?*
    - In response to commenters, the Commission noted in the Adopting Release that while most closed-end funds do strike their NAV on at least a monthly basis, those funds that do not do so may report information on Form N-PORT by using their internal methodologies consistent with how they report internally and to current and prospective investors, as allowed by General Instruction G to Form N-PORT. Funds that value their holdings by relying upon their internal methodologies in this manner may provide additional information in Part E (explanatory notes to Form N-PORT) explaining the internal methodology.

- **N-CEN**
    - *Item C.10.vii of Form N-CEN requires funds to report information on sub-transfer agents. Are funds required to report information on intermediaries, such as broker-dealers, that provide "sub-transfer agent" or administrative services for their customers whose shares are maintained in omnibus accounts with the fund's primary transfer agent?*
        - No. Item C.10.vii requires funds to report their transfer agent arrangements, including arrangements where systems, transaction processing and services are provided by sub-transfer agents in supporting the fund's primary transfer agent systems and recordkeeping functions (such as part of a remote systems or hybrid or fully outsourced arrangement).
        - In the staff's view, for purposes of Item C.10.vii, funds do not need to identify intermediary arrangements (e.g., with broker-dealer firms and other intermediaries such as retirement plan third-party administrators) that are administrative service type arrangements (also sometimes referred to as "sub-accounting" and "sub-transfer agent" arrangements), because such firms are engaging with the primary transfer agent as record owners of fund shares and conducting transactions with fund's transfer agent on behalf of their customers who are beneficial or underlying shareholders in funds, and such arrangements are not part of the primary transfer agent's recordkeeping arrangement with the fund, as described above.

- **S-X Changes**
    - S-X changes took effect on August 1, 2017

The complete FAQs can be found at: https://www.sec.gov/investment/investment-company-reporting-modernization-faq

SEC and FINRA Continue to Bring Cases Related to the Recommendation and Purchase of Higher-Cost Share Classes

Cases involving the recommendation and purchase of classes of shares that have higher fees than other available share classes continue to be a focus of the SEC, FINRA, and shareholders. One case that has been going on for 10 years is a class action suit brought by employees of Edison International. In this case, the plaintiffs prevailed by demonstrating the 401(k) sponsor breached its fiduciary duty by not choosing less expensive institutional shares of certain funds after such classes of shares became available. The damages, covering the period from 2001 to 2011, were stipulated by the parties to be $7.5 million. Awards covering the period from 2011 to the present have yet to be determined.

In a separate case, SunTrust Investment Services ("SunTrust") agreed to a $1.1 million settlement with the SEC. This case involved allegations that clients participating in SunTrust's advisory wrap programs purchased Class A mutual fund shares which paid 12b-1 fees instead of purchasing institutional class shares of the same funds without such fees. The SEC alleged that SunTrust did not adequately disclose the conflicts of interest in the share class selections and that the firm's compliance procedures with respect to these issues was deficient.

Also in September, Envoy Advisory agreed to settle similar charges involving a period from January 2013 to March 2017 for $26,000.

It is believed by some that the SEC still has a pipeline of similar cases to bring involving matters that it has uncovered as part of their routine examinations.

Escheatment Update: Texas "Representative for Notice" Requirement Takes Effect

A new requirement that mutual funds alert clients purchasing shares in Texas of the ability to designate a "representative for notice" took effect on September 1. Under Texas law H.B. 1454, the purpose of such representatives is to receive notices of escheatment on behalf of the account owner. Additionally, a representative may establish contact with the fund company on the owner's behalf in order to cease the running of Texas' three-year period of abandonment by confirming that he/she knows the owners' location and that the owner exists and has not

abandoned the account. Representatives for notice do not have any rights with respect to the mutual fund accounts. Notice of the ability to designate a representative must be provided to new mutual fund investors at the time of their initial purchase.

ICI Submits Recommendations to SEC on Liquidity and Fund Reporting Rules

The ICI submitted a letter to new SEC Chairman Clayton in July requesting a delay in the compliance schedule for the Liquidity Rule and to propose and finalize targeted rule amendments. Proposed Rule amendments should permit each fund to formulate its own policies and procedures to determine how to classify the liquidity if its investments. Even if the proposed amendments are not pursued, the ICI proposed a one-year delay in compliance with the Rule.

For the Financial Reporting Modernization the ICI proposed quarterly instead of monthly reporting of holdings until the SEC can address security concerns. Even if the proposed amendments are not pursued, the ICI recommended a six-month delay in the filing requirements.

ACCOUNTING UPDATE

Deloitte Releases 15th Annual Fair Valuation Pricing Survey

Deloitte released the 15th Annual Fair Valuation Survey. Key findings were:

- **Private equity valuation.** No matter how much exposure to private equity investments a manager has, estimating their value remains a challenge—and a concern for more than half our respondents. Calibration according to GAAP can be a useful tool, but few industry practices are set in stone.
- **Odd-lot valuation.** Before valuing odd-lots, managers need a consistent system for defining and identifying them. Then they need some basis in data for valuing such an asset differently from the way they would value a round-lot. Almost half the survey respondents have performed analyses to determine if odd-lots should be valued at an amount different than the price used for a round-lot. And almost a quarter have changed their policies on odd-lots.
- **Consideration of pricing vendors.** Every year, investment companies say they're willing to re-evaluate their pricing sources. With recent merger activity among those vendors, that practice may accelerate. This year's survey finds significantly more companies are adding or changing their secondary pricing sources.
- **Stepping up management practices** - This year's survey brought to light some other notable findings relating to valuation policies and procedures, board governance, and specific investment types. In regards to board governance, this year's survey revealed that more firms are investing in risk valuation dashboards, and that it has become more common for members of the board to receive information on price challenges. And when it comes to overall management, just under two-thirds of those surveyed said their companies have a specific employee responsible for managing and overseeing the valuation process. These findings and others are detailed in the survey executive summary.
- **Looking ahead** - Investment companies continue to focus on having the right people and processes in place to achieve their best estimates of fair value for each investment and their shareholders. Over the coming year, finding new ways to meet objectives, governance matters, understanding the nuances of available investments, implications of new regulation, and industry challenges—including increased technology capabilities—are areas of particular focus for investment companies.

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 Regarding Elective Stock Dividends by REITs and RICs

The IRS has issued guidance regarding certain stock distributions by regulated investment companies ("RIC"s) and real estate investment trusts ("REIT"s). Specifically, Revenue Procedure 2017-45 provides that the IRS will treat the distribution of stock as a distribution of property, to which IRC Section 301 applies by reason of Section 305(b), if a Publicly Offered RIC or a Publically Offered REIT distributes stock in a transaction meeting the requirements of the revenue procedure.

If a Publicly Offered RIC or a Publicly Offered REIT makes a distribution of stock in a transaction that satisfies the following requirements of the revenue procedure, then the IRS will treat the distribution of stock as a distribution of property to which Section 301 applies by reason of Section 305(b):

- A Publicly Offered RIC or a Publicly Offered REIT makes a distribution to its shareholders with respect to its stock.
- Pursuant to the declaration of the distribution, each shareholder has a Cash-or-Stock Election with respect to part or all of the distribution. The existence of a Cash-or-Stock Election does not affect the federal income tax treatment of the portion, if any, of the declared dividend that is not subject to the election.
- The Cash Limitation Percentage is not less than 20 percent.
- Every shareholder that is not an Excess Cash Claimant receives cash equal to the shareholder's Elected Cash Amount
- If the aggregate of all shareholders' Elected Cash Amounts does not exceed the Cash Limitation Amount, then every Excess Cash Claimant receives cash equal to that shareholder's Elected Cash Amount.
- If the aggregate of all shareholders' Elected Cash Amounts exceeds the Cash Limitation Amount, then each Excess Cash Claimant receives an amount of cash that is as close in amount as practicable to the sum of -
    - The product of the Cash Limitation Percentage and that shareholder's Entire Affected Distribution; and

- The product of the Available Cash and the ratio of -
    - That shareholder's Excess Cash Claim to
    - The aggregate of the Excess Cash Claims of all Excess Cash Claimants.

- The calculation of the number of shares to be received by a shareholder is determined based upon a formula that -
    - Utilized the market price of the shares;
    - Is designed so that the value of the number of shares to be received in lieu of cash with respect to a share corresponds as closely as practicable to the amount of cash to be received under the declaration with respect to that share; and
    - Uses data from a period of no more than two weeks ending as close as practicable to the payment date.

The value of the stock received by any shareholder in lieu of cash will be considered to be equal to the amount of cash for which the stock is substituted, as described in the revenue procedure. For purposes of the revenue procedure, if a shareholder participates in a dividend reinvestment plan, the stock received by that shareholder pursuant to the dividend reinvestment plan is treated as received in exchange for cash received in the distribution.

Revenue Procedure 2017-45 is effective with respect to distribution declared on or after August 11, 2017.

IRS Provides Penalty Advice Related to Deficiency Dividends Deduction by a RIC or a REIT

The IRS in a recently issued Chief Counsel Advice Memorandum concluded that in general, a RIC or a REIT that is allowed a deficiency dividends deduction under Internal Revenue Code ("IRC") Section 860(a) is not liable for an addition to tax under IRC Section 6651(a)(1) or (2) for failure to timely file a return or timely pay the amount shown on a return. Further, a RIC or a REIT that is allowed a deficiency dividends deduction under IRC Section 860(a) is not liable for any accuracy-related penalty under IRC Section 6662 on an underpayment resulting from the deemed increase in tax under IRC Section 860(c) and is not liable for any other addition to tax, additional amount or penalty under Chapter 68 of the IRC for taxable years beginning after December 22, 2010.

The IRS may use Letter 105C to communicate to a RIC or a REIT that its claim for a deficiency dividends deduction was denied or allowed. There are ways in which a RIC or REIT might be able to secure administrative review of the denial of a claim for a deficiency

dividends deduction. The memorandum briefly discusses avenues for administrative and judicial review.

IRS Rules on Foreign Currency Hedging Transactions of RIC

The IRS recently issued a Private Letter Ruling 201728003 granting the taxpayer permission to use the tax accounting method described in the ruling for determining the timing, character and amount of foreign currency related gain or loss on foreign currency denominated bonds and the forward contracts entered into for the purpose of hedging the right to receive foreign currencies on such bonds for the following reasons:

The investment fund that is being hedged has been designed to track the performance of an index created by a third party, which includes minimizing the effect of foreign currency gains and losses.

The underlying assets that are being hedged under the taxpayer's foreign currency hedging method are bonds which are part of a publicly available investment fund.

The taxpayer's proposed hedging method is a foreign currency hedging method designed for the purpose of reducing economic exposure to the foreign currency risk associated with the foreign currency denominated payments received on the bonds which might adversely affect returns on the fund to the public investors.

The taxpayer has a process and internal controls and procedures in place to ensure that it achieves the results of mirroring the index.

The ruling is directed only to the taxpayer requesting it.

IRS Rulings Offer RICs Relief for Not Making Timely 853 Elections

The IRS recently issued Private Letter Rulings that provide relief to regulated investment companies (“RIC”s) that failed to make timely elections to pass through the foreign taxes paid by the RICs. Relief under Internal Revenue Code Section 301.9100-1 and 301.9100-3 may be granted if the taxpayer acted reasonably and in good faith and where the interests of the government are not prejudiced. In the rulings issued by the IRS, the RICs failed to make elections by the due date for the elections and requested the IRS to grant relief to make the elections.

International / FATCA

ICI Letter on EU Reclaims and Closing Agreement Methodology

The Investment Company Institute ("ICI") submitted a letter, dated July 18, 2017, to the Internal Revenue Service (IRS), that which discussed issues in applying Notice 2016-10, Guidance Relating to Refunds of Foreign Tax for Which an Election Was Made Under Section 853. The letter follows up on the ICI's suggestion that the industry utilize an agreed methodology for calculating the "compliance fee" required by any fund seeking a closing agreement. The letter also urges the IRS's reconsideration of the treatment of interest under the Notice's netting procedure. Finally, although the ICI doesn't discuss the issue at length in the letter, the ICI reiterates their proposal that RICs be permitted to use netting even when netting can be achieved only by carry forward excess tax recoveries for some limited number of years. Until published guidance can be issued, RICs should be permitted to enter into closing agreements that allow netting.

The ICI proposes the following five steps for calculating the compliance fee required by any fund seeking a closing agreement:

Step 1: Determine the porting of taxable versus tax-exempt investors.

Step 2: Multiply the amount of the recovered ("refunded") taxes by the taxable shareholder percentage. The product of this calculation is the "unadjusted fee amount".

Step 3: To determine the "compliance fee" that the RIC will pay pursuant to the closing agreement, multiply the unadjusted fee amount (as determined in Step 2) by a factor that reflects the additional tax that will be collected when the RIC distributes to shareholder the portion of the refunded tax that is not paid over to the US Treasury pursuant to the closing agreement.

Step 4: The RIC will treat as investment company taxable income the excess of the refunded amount over the compliance fee. The RIC will then distribute this excess to shareholder in order to satisfy the general RIC distribution requirements and avoid a RIC-level tax on the income.

Step 5: The excess refund distribution will be characterized as "qualified dividend income" (or not), as discussed in the ICI's April 2016 submission, based on the nature of the previously-included income on which the tax was paid.

Other

2017 Year-End Reporting Layouts and Target Delivery Dates

The Investment Company Institute ("ICI") released their calendar 2017 year-end reporting layouts and target delivery dates. The Primary Layout has been designed to track the IRS Form 1099-DIV. The Secondary Layout provides a means for regulated investment companies ("RICs") to use to report various additional tax related items. The NRA Layout provides a means for reporting information on IRS Form 1042-S. All calendar 2017 layouts are identical to their respective 2016 layout.

Funds are encouraged to provide their year-end tax information to brokers and banks as soon as it is available. The target dates for delivering year-end tax information to brokers and banks will be as follows: Primary Layout - Tuesday, January 16, 2018; Secondary Layout – Monday, January 22, 2018; and NRA Layout – Tuesday, February 6, 2018.

Investment Company Institute's 2017 Tax & Accounting Conference – Tax-Related Panels and Topics

The ICI 2017 Tax & Accounting Conference included several financial, regulatory and tax related panels discussing various issues and topics.

The tax reform in 2017 panel topics included elements for comprehensive tax reform, 1986 - the last successful tax reform effort, 21st century efforts - 2001-2016, current proposals, and implications for the fund industry. The reforming the taxation of derivatives panel topics included prospects for derivatives reform, Camp 2014 tax reform bill, modernization of derivatives tax act ("MODA") of 2017 - basics and investment hedging unit regime and cases studies of derivatives in equity fund and bond funds. The international tax issues panel topics included the changing international dynamic - post-2008 financial crisis, taxing cross-border investments, and taxing cross-border activities. The product rationalization panel topics included RIC mergers and RIC liquidations. The complex securities and products panel topics included new security process, new service providers, complex fixed income securities, complex derivatives and unique security types and transactions. The corporate actions panel topics included overview, identification, processing and consequences.

CYBER UPDATE

SEC Announces Cyber Initiatives to Combat Threats and Protect Investors

On September 25, 2017, the Securities and Exchange Commission announced two new initiatives to supplement its efforts to address cyber-based threats and protect retail investors. First, the Commission created a "Cyber Unit" that will focus the Division of Enforcement's cyber-related expertise on targeting cyber-related misconduct, including:

- Market manipulation schemes involving the spread of false information through electronic or social media.
- Hacking to obtain nonpublic information.
- Violations involving distributed ledger technology and initial coin offerings.
- Misconduct perpetrated through the dark web.
- Intrusions into retail brokerage accounts.
- Cyber-related threats to trading platforms or other critical market infrastructure.

Next, the Commission created a "Retail Strategy Task Force" which will "develop proactive, targeted initiatives to identify misconduct impacting retail investors." The task force will combine the Division of Enforcement's experience bringing cases involving fraud against retail investors with data analytics and technology to identify large-scale misconduct. The task force will include personnel from across the Commission, including the Commission's National Exam Program and Office of Investor Education and Advocacy.

SEC Cybersecurity Update – OCIE's Observations from Cybersecurity Examinations

On August 7, 2017, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") released a cybersecurity Risk Alert discussing the findings of its examinations of 75 firms conducted between September 2015 and June 2016 under its "Cybersecurity 2 Initiative." The Cybersecurity 2 Initiative focused on the following areas: (1) governance and risk assessment; (2) access rights and controls; (3) data loss prevention; (4) vendor management; (5) training; and (6) incident response. OCIE staff observed increased cybersecurity preparedness compared to its "Cybersecurity 1 Initiative" conducted in 2014, noting that firms had implemented additional cybersecurity practices, such as:

- Periodic risk assessments of critical systems to identify cybersecurity threats, vulnerabilities, and potential consequences of a cyber incident.
- Penetration testing and vulnerability scans on critical systems.
- Implementation of systems, utilities or tools to prevent, detect and monitor data loss relating to personally identifiable information.
- Regular system maintenance, including the installation of software patches addressing security vulnerabilities (although some firms had a significant number of patches that had not yet been installed).
- Policies and procedures addressing cyber-related business continuity planning and Regulation S-P and response plans for addressing cyber-related incidents.
- Maintenance of cybersecurity organizational charts and/or identified and described roles and responsibilities for the firms' workforce.
- Authority from customers to transfer funds to third-party accounts.
- Vendor risk assessments both at the initiation of the vendor relationship and periodically (annually) thereafter.

In addition to the cybersecurity practices observed by OCIE staff, it noted certain issues affecting the vast majority of the firms examined, including:

- Cyber-related policies and procedures not reasonably tailored to the firm's business and contradictory policies.
- Failure to adhere to, or enforce, cyber-related policies and procedures. In some cases, firm policies and procedures did not reflect the firm's actual practices.
- Regulation S-P related issues, such as the use of outdated operating systems no longer supported by security patches, and failure to remediate high-risk findings of penetration tests and vulnerability scans.

Finally, OCIE provided a list of elements that firms may wish to consider in order to implement "robust" cybersecurity policies and procedures, including:

- Maintenance of an inventory of data, information, and vendors along with classification of the risks presented by each service provider/vendor.
- Detailed cybersecurity-related instructions covering penetration tests, security monitoring and system monitoring, access rights, and reporting.

- Maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities.
- Established and enforced controls to access data and systems.
- Mandatory employee training.
- Engaged senior management.

Firms should expect OCIE to continue to examine firms' cybersecurity compliance procedures and controls, including the effective implementation of such procedures and controls.