# Industry Trends – August 2017

## Industry Statistics – Mutual Funds

| Fund Category | Net Assets (in billions) | | Percentage Change in Net Assets | Dollar Change in Net Assets (in billions) | Change Due to | |
|---|---|---|---|---|---|---|
| | Jun - 17 | Mar - 17 | | Total Change | Net Cash Flows | Market |
| Stock | $9,460.1 | $9,117.8 | 3.8% | $342.3 | ($17.1) | $359.4 |
| Hybrid | $1,454.4 | $1,433.0 | 1.5% | $21.4 | ($7.3) | $28.7 |
| Taxable Bond | $3,239.7 | $3,147.8 | 2.9% | $91.9 | $53.4 | $38.5 |
| Municipal Bond | $645.2 | $628.6 | 2.6% | $16.6 | $7.1 | $9.5 |
| Money Market | $2,633.4 | $2,664.2 | (1.2%) | ($30.8) | ($33.6) | $2.8 |
| **Total** | $17,432.8 | $16,991.4 | 2.6% | $441.4 | $2.5 | $438.9 |

- Stock funds assets had an increase during the quarter of $342.3 billion. For the quarter ended June 30, 2017, market appreciation was $359.4 billion compared to an appreciation of $561.9 billion for the quarter ending March 31, 2017. The net assets for stock funds increased from $9,117.8 billion as of March 31, 2017 to $9,460.1 billion at the end of the second quarter of 2017.

- Hybrid fund assets increased from $1,433.0 billion as of March 31, 2017 to $1,454.4 billion as of June 30, 2017. This compares to an increase of $44.3 billion in the first quarter of 2017. The increase was the result of market appreciation of $28.7 billion and net outflows of $7.3 billion.

- Bond funds had net inflows of $60.5 billion for the quarter ended June 30, 2017, compared to the previous quarter inflows of $74.3 billion. Assets for all bond funds increased $108.5 billion for the quarter ended June 30, 2017 which included, market appreciation of $48.0 billion.

- Money market funds had net outflows of $33.6 billion for the three months ended June 30, 2017, compared to the previous quarter outflows of $66.5 billion. Money market fund net assets, over the three month period decreased from $2,664.2 billion as of March 31, 2017 to $2,633.4 billion as of June 30, 2017.

Source: Investment Company Institute website

## Regulatory Update

### SEC Settles Two More Distribution in Guise Cases

In early May, the SEC released two settled administrative proceedings involving violations relating to payments for distribution and sub-transfer agency ("sub-TA") services.

In the first case, the SEC fined William Blair $4.5 million in connection with an investigation into improper distribution and sub-TA payments the William Blair Funds made during a four-year period ending in 2014. The settlement order describes a number of inadvertent misclassifications and negligent conduct that led the funds (not the adviser) to make approximately $1.25 million in payments to four intermediaries during the four-year period for distribution of sub-TA services. Additionally, the SEC found that William Blair did not fully disclose a conflict of interest to fund directors involving a shareholder administration agreement. At the time of initial board approval, management represented that it expected to pass through the 15 basis point fee to intermediaries that provided services. In actuality, William Blair retained the fees for providing the shareholder administration services, directly or indirectly, for the third party intermediaries. The SEC further noted that William Blair caused the funds to make payments to two intermediaries in the amount of $901,947 for marketing and distribution services outside of a Rule 12b-1 plan. In another instance, the funds paid certain sub-TA costs beyond a cap established by the board of directors.

The second case involved Calvert Investment Management ("CIM") and Calvert Investment Distributors ("CID"). Collectively, Calvert agreed to pay more than $22 million to settle SEC charges that it used fund assets instead of the firm's profits to pay for marketing and distribution services and sub-TA services over a seven-year period. One example cited by the SEC involved a marketing support agreement between CID and an intermediary whereby CID was to provide financial support from its own resources to promote fund sales but instead used fund assets earmarked for sub-TA services to pay for the marketing activities. The SEC further asserted that CIM and CID improperly used fund assets to pay millions of dollars in fees for sales and marketing activities. In total, CIM and CID misused $14.87 million in fund assets to pay for marketing and distribution activities outside of a Rule 12b-1 plan. Moreover, there were inaccurate disclosures to the fund boards regarding fees paid for marketing and distribution.

The SEC continues to note that distribution in guise remains a focus of their investigations.

## SEC Amends Form ADV

On August 25, 2016, the SEC adopted amendments to Form ADV and certain recordkeeping rules applicable to investment advisers. The amendments were initially proposed on May 20, 2015 with the comment period ending on August 11, 2015. The final rule became effective on October 31, 2016 with a compliance date of October 1, 2017.

The amendments require advisers registering on Form ADV to report additional information with an emphasis on separately managed accounts ("SMA"s). Additionally, advisers will be required to comply with certain recordkeeping requirements related to communications of performance or securities recommendations. The amendments are intended to provide data regarding a perceived gap in information involving SMAs.

As noted above, the amendments require advisers to report more information about their SMAs. SMAs include all advisory accounts but for pooled investment vehicles. Beginning with filings after October 2017, advisers will need to provide information on an aggregate level about the SMAs they manage, regulatory assets under management attributable to SMAs ("RUAM") and the types of assets held across 12 categories and the use of derivatives and borrowings in the SMAs.

Advisers with at least $500 million, but less than $10 billion, in RUAM attributable to SMAs are required to provide certain information as a part of their annual amendment update. Advisers in this category are required to report the amount of RUAM in SMAs and the dollar amount of borrowings attributable to those assets.

Advisers with at least $10 billion are required to report the RUAM in SMAs and the dollar amount of borrowings associated with those assets and the derivative exposure in each of six categories of derivatives. The borrowings must be reported based on the total dollar amount of borrowings that corresponds to the different ranges of gross notional exposure.

The amendments also require advisers to identify custodians that account for at least 10% of SMA RUAM and the amount held at each custodian.

The amendments further require advisers to report any social media accounts used by the adviser where the adviser controls the content, including the addresses of the adviser's social media pages. Form ADV previously required advisers to only report their website address.

The amendments require advisers to report the total number of offices where they offer investment advisory services and the 25 largest offices based on the number of employees. With respect to each office, the adviser must report:

- Central Registration Depository ("CRD") branch numbers, if applicable;

- The number of employees acting in an advisory capacity;
- The business activities that take place according to a list of activities provided by the SEC; and
- Any other investment activities conducted.

The amendments further require an adviser to disclose whether it Chief Compliance Officer ("CCO") is employed by a third party. If this is the case, the adviser is required to disclose the name and IRS Employer Identification Number of that third party.

The SEC also adopted some significant changes to Rule 204-1 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The amendments require advisers to make and maintain supporting documentation that demonstrates performance calculations or rates of return in any written communications the adviser circulates or distributes to any person.

## SEC Issues Public Statement Requesting Comments on Implications of DOL's Fiduciary Rule

Jay Clayton, SEC Chairman, recently made a public statement indicating that the SEC's desire to work constructively with the Department of Labor ("DOL") to analyze the applicable standards of conducts under the so-called "Fiduciary Rule." Chairman Clayton stressed the importance of clarity and consistency as key elements of effective joint-oversight by the DOL and SEC. Noting the significance of the issues at stake, Chairman Clayton invited public input to facilitate a robust dialogue and help guide any future action by the SEC. The SEC is seeking comments in seventeen topic areas, some of which include investor knowledge of related issues, potential harm to investors, costs and benefits related to various paths the SEC or DOL could take, and the impact any future action would have on different segments of the market.

## CFTC Staff Clarifies Ability of Registered CPOs to File Consolidated Annual Reports

On May 3rd, the staff of the Commodity Futures Trading Commission ("CFTC") issued a letter to the Investment Company Institute clarifying the ability of advisers to funds that are registered with the CFTC as commodity pool operators, and that invest in commodities through wholly-owned controlled foreign corporations ("CFCs"), to satisfy their obligation to file annual reports under CFTC regulation 4.22(c) by using an audited consolidated schedule of investments that includes the holdings of both the registered fund and its CFCs.

ICI had requested that the CFTC staff clarify that it is not necessary for registered fund CPOs to *separately indicate* the holdings, gains and losses, and other financial statement amounts

attributable to the CFC, because separate identification is inconsistent with the objectives of consolidated financial reporting and investment company reporting practices.

## CFTC Strengthens Anti-Retaliation Protections for Whistleblowers

On May 22, 2017, the Commodity Futures Trading Commission (the "CFTC") amended its Whistleblower Rules that will strengthen the anti-retaliation protections for whistleblowers and enhance the whistleblower claims process. The amendments prohibit employers from taking steps to impede potential whistleblowers from communicating with CFTC staff about possible violations, including the use of confidentiality or pre-dispute arbitration agreements. In addition, the amendments allow for either the whistleblower or the CFTC to initiate action against an employer for retaliation against a whistleblower. These changes harmonize the CTFC's anti-retaliation provisions with those of the Securities and Exchange Commission.

## Supreme Court Limits SEC's Power to Obtain Disgorgement

On June 5, 2017, The Supreme Court of the United States released a unanimous decision in *Kokesh v. Securities and Exchange Commission* which limits the time period over which the SEC may seek disgorgement of fees.[1] The issue before the Court was whether the SEC's ability to obtain disgorgement is subject to the five-year statute of limitations that applies to any "action, suit or proceeding for the enforcement of a civil fine, penalty, or forfeiture." The Court noted that disgorgement "bears all the hallmarks of a penalty" and should therefore be subject to the five-year statute of limitations. The hallmarks of a penalty enumerated by the Court included the fact that disgorgements are (i) "imposed as a consequence of violating a public law," (ii) imposed for punitive purposes, such as deterrence, and (iii) not compensatory.

The *Kokesh* decision is likely to result in changes to the way in which the SEC conducts investigations and enforcement actions going forward. For example, the SEC may seek prioritize cases relating to actions that are approaching the five-year limitation. Additionally, the SEC may rely more heavily on tolling agreements under which an entity under investigation consents to freeze or extend the statutory period in an effort to avoid litigation. In each of its last two fiscal years SEC enforcement actions have resulted in more than $4 billion in disgorgement and penalties.

[1] *Kokesh* involved the misappropriation of almost $35 million from business development companies managed by the petitioner's registered investment advisers between 1995 and 2006.

## Department of Labor Fiduciary Rule Phased-in Implementation Process Begins

On June 9, 2017 two significant components of the Departments of Labor's "fiduciary rule" became effective: (i) the expanded definition of the term "fiduciary" and (ii) the duty to comply with the Impartial Conduct Standards. The implementation of certain conditions for impacted exemptions has been delayed until January 1, 2018. Furthermore, the Department of Labor stated that is will not pursue enforcement actions against fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and exemptions. The Department of Labor also issued Conflict of Interest FAQs which highlighted compliance timelines and requirements and provided examples of selected customer interactions and whether they give rise to fiduciary status.

Under the components of the rule that became effective on June 9, 2017, fiduciaries under the rule must: give advice to the retirement investor that satisfies the prudence and loyalty standards; charge no more than reasonable compensation; and not make misleading statements with respect to investment transactions, compensation and conflicts of interest.

In the meantime, the Department of Labor will continue its analysis of whether the fiduciary rule harms retirement investors or the industry as required by President Trump's February 3, 2017 executive order. Department of Labor Secretary Alexander Acosta has indicated that the rule may be further revised and/or that implementation of components of the fiduciary rule may be further delayed.

The Investment Company Institute ("ICI") has reported that it believes more than half a million of small retirement accounts have been offloaded by brokers since April 2016 as a result of the rule and continues to push for a solution that is the joint effort of the SEC and Department of Labor. The ICI will also be submitting comments regarding the costs and compliance issues associated with broker compliance.

## Privileged Communications and Fund Boards

In December 2016, a Washington state federal court found that the rights of mutual fund shareholders in advisory fee litigation trumped the rights of mutual fund independent trustees to attorney-client confidentiality. In the Section 36(b) case, a disgruntled investor alleged excessive advisory fees. The investor wanted to include, as part of the litigation, emails and communications among the independent trustees and their legal counsel. The judge found that shareholders were the actual clients of fund counsel and the independent trustees were simply acting as fiduciaries for the shareholders. Therefore, the privilege on the communications rests with the shareholders rather than the independent trustees. The case is still in discovery phase,

but the investor's access to the communications at issue could undoubtedly shape the outcome of the case.

In May 2017, an Illinois federal court came to a different conclusion in another Section 36(b) case. In that decision, the court held that mutual fund shareholders were not entitled to obtain access to privileged communications among independent trustees and their counsel. The judge not only acknowledged the independent trustee's attorney-client privilege, but also ruled that the fund shareholders needed to show "good case" for rebutting the trustees' privilege and failed to do so.

## FINRA Issues Guidance on Social Media and Digital Communications

Recent studies report that 65% of adults use social networking sites and 64% of adults own a smart phone. Accordingly, these trends continue to raise questions regarding the application of FINRA rules to social media and digital communications.

On April 17, FINRA issued Regulatory Notice 17-18 offering guidance on social networking websites and business communications. FINRA has addressed this general topic on at least two prior occasions (FINRA Regulatory Notice 10-06 and FINRA Regulatory Notice 11-39), focusing on issues such as use of personal devices for business communications, recordkeeping and how FINRA Rule 2210 applies to certain communications such as third-party posts and links to third-party sites.

FINRA states that this latest guidance is not intended to alter the principles or guidance provided in the prior Regulatory Notices. After summarizing its prior guidance, FINRA provides new guidance on text messaging, personal communications, hyperlinks and sharing, native advertising, testimonials and endorsements, corrections on third-party content, and BrokerCheck in a Q&A format.

This recent Regulatory Notice provides additional clarity for firms and their registered representatives as they weigh the benefits versus the supervisory and compliance risks associated with the use of social media and digital communications.

Link to FINRA Regulatory Notice 17-18

## ACCOUNTING UPDATE

### PCAOB Adopts Changes to Auditor's Report

The Public Company Accounting Oversight Board ("PCAOB") recently adopted changes to the auditor's report. The new standard requires the auditor to disclose in their report the year in which the firm began serving consecutively as the company's auditor. Because investment companies typically have common accounting, internal control, and oversight functions at the complex level, the new audit standard measures audit firm tenure based on the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. The auditor's report would include a statement such as: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

The new audit standard includes several additional changes intended to clarify the auditor's role and responsibility, including: 1) a statement that the auditor is required to be independent; 2) the auditor's report will be addressed to the company's shareholders and board of directors; and 3) adding the phrase "whether due to error or fraud" when describing the auditor's responsibility to obtain reasonable assurance that the financial statements are free of material misstatement.

Subject to approval by the SEC, the new audit standard will take effect as follows: all provisions will take effect for audits of fiscal years ending on or after December 15, 2017.

## TAX UPDATE

***Regulatory***

### Reissuance of Proposed Regulations on Partnership Rules

The Internal Revenue Service (IRS) and the U.S. Treasury Department (Treasury) re-issued proposed regulations that are nearly identical to proposed regulations that were previously issued in January and withdrawn soon after issuance following an executive order from the Trump Administration. The proposed regulations were issued to provide guidance on the new partnership audit regime that was enacted as part of the Bipartisan Budget Act of 2015 (BBA). The BBA repeals the current rules governing partnership audits and replaces them with a new centralized partnership audit regime that, in general, assesses and collects tax at the partnership level.

Under the new rules, any adjustments for a partnership tax year are taken into account by the partnership and not the individual partners, in the year that the audit is completed. Alternative audit procedures are available under the new rules, in which the partnership may elect to furnish to each reviewed-year partner a statement setting forth each partner's share of any partnership adjustments.

The proposed regulations provide rules for partnerships subject to the new regime, including procedures for electing out of the centralized partnership audit regime, filing administrative adjustment requests, and the determination of amounts owed by the partnership or its partners attributable to adjustment that arise out of an examination of a partnership. The proposed regulations also address the scope of the centralized partnership audit regime and provide definitions and special rules that govern its application, including the designation of a partnership representative.

The proposed regulations coordinate the rules under the centralized partnership audit regime with the deficiency dividend procedures under the RIC rules for partners that are RICs. In general, the deficiency dividend procedures under the RIC rules allow RICs to be relieved from the payment of a deficiency in (or to receive a credit or refund of) certain taxes and if the entity fails the distribution requirement. The deficiency dividend procedures allow an additional deduction for "deficiency dividends" that meets the deficiency dividend requirements in computing the deduction for dividends paid for the taxable year for which a "determination" is made. Under the proposed regulations, if a statement is furnished to a reviewed year partner that is a RIC, the RIC may take into account the adjustments reflected in the statements that also are "adjustments" within the meaning of the deficiency dividend rules by using the deficiency dividend procedures, subject to the limitations in the proposed regulations.

Accordingly, a RIC may utilize the deficiency dividend procedures if the RIC receives a statement from a partnership that includes adjustments within the meaning of the deficiency dividend rules.

If the RIC utilized the deficiency dividend procedures with respect to adjustments in a statement described in the proposed regulations, the RIC may claim a deduction for deficiency dividends against the adjustments furnished to the RIC in calculating any correction amounts for the first affected year and any intervening year to the extent that the RIC makes deficiency dividend distributions under the deficiency dividend rules and complies with all requirements of the deficiency dividend rules and regulations.

If a RIC claims a deficiency dividends deduction, interest under the proposed regulations is only calculated on any correction amount determined after deducting any deficiency dividend deduction from the adjustment taken into account by the RIC. Nothing in the proposed regulations affects a RIC's liability for any interest on the deficiency dividend distribution under the deficiency dividend rules. Therefore, a RIC will be liable for interest under the deficiency dividend rules as to any deficiency dividend distribution as well as interest on any correction amount determined under the proposed regulations. Because the deficiency dividend distribution is deductible in calculating the correct amounts, in no event will a RIC pay both interest under the deficiency dividend rules and the proposed regulations as to the same amount.

As clarified in the proposed regulations, a deficiency dividend deduction used in calculating any correction amount has no effect on a RIC's liability for any penalties reflected in the statement furnished to the RIC under the proposed regulations.

The proposed regulations affect partnerships for taxable years beginning after December 31, 2017, though partnerships may elect to apply the new rules to returns filed for partnership taxable years beginning after November 2, 2015, the date enactment of the BBA and before January 1, 2018.

## ICI Submits Recommendations for IRS 2017-2018 Priority List

The Investment Company Institute (ICI) submitted a letter dated June 1, 2017 to the Internal Revenue Service (IRS) and U.S. Treasury Department (Treasury) recommending tax related issues affecting regulated investment companies (RICs) and their shareholders for inclusion on the 2017-2018 Guidance Priority List.

The ICI submitted recommendations, including guidance regarding (1) foreign tax recoveries from European Union member States under Santander, (2) foreign account tax compliance act (FATCA), (3) items related to the RIC Modernization Act of 2010, (4) deemed distribution

under Section 305(c), (5) cost basis reporting, (6) foreign bank and financial account reporting (FBAR), (7) ownership tracking requirements, (8) electronic filing, (9) section 529 qualified tuition programs, (10) section 8510 and investments in controlled foreign corporations (CFC) and passive foreign investment companies (PFICs), and (11) money market fund reform.

## IRS Releases Rulings Revoking Prior CLN Rulings issued to RICs

Prior private letter rulings (PLRs) on qualifying income from commodity-linked notes for regulated investment companies (RICs) were revoked as not in accordance with the current views of the Internal Revenue Service (IRS). From 2007 to 2011, the IRS issued PLRs ruling that certain income and gains from commodity-linked notes constitute qualifying income for RICs, such as mutual funds or exchange-traded funds.

In September 2016, the IRS issued proposed regulations to change the treatment of commodity income for RICs and notified all affected taxpayers that it was considering revoking the PLRs because they were not in accordance with the views with the IRS.

The IRS revoked the rulings and stated that the revocation of the PLRs, for which the taxpayers had requested the IRS to limit the retroactive effect of the revocation, will apply prospectively only to commodity-linked notes acquired after June 30, 2017. The revocation of the PLRs for which the taxpayers failed to make such requests will apply retroactively to all years open under the statute of limitations on assessment as of April 21, 2017, and to all future years.

***State***

## New York State Resolves RIC Tax Issue

New York State amended its laws, effective for taxable years beginning on or after January 1, 2016, to resolve a tax issue affecting regulated investment companies (RICs) so that RICs are now subject to a minimum tax of no more than $500 (for New York receipts of more than ($500,000). Alternatively, RICs may use the prescribed 8% New York receipts factor for purposes of apportionment.

For the taxable year beginning on or after January 1, 2015, and before January 1, 2016, for this year only, the New York State Department of Taxation and Finance will permit RICs to use the 8% receipts factor for purposes of apportionment, even if the taxpayer was not otherwise eligible to make the fixed percentage election under the law before it was amended for the tax year 2016.

## OTHER

### Trends in Fees and Expenses of Funds

The ICI released its annual research report on fees and expenses on funds in 2016. Key findings were as follows:

- On average, expense ratios for long-term mutual funds have declined substantially over the past 20 years. In 1996, equity mutual fund expense ratios averaged 1.04 percent, falling to 0.63 percent in 2016. Bond mutual fund expense ratios averaged 0.84 percent in 1996 compared with 0.51 percent in 2016. Hybrid mutual fund expense ratios averaged 0.95 percent in 1996, falling to 0.74 percent in 2016.
- The average expense ratios for money market funds rose 5 basis points in 2016 to 0.18 percent. This was prompted by fund advisers beginning to pair expense waivers that most money market funds offered during the period of near-zero short-term interest rates.
- Expense ratios of target date mutual funds averaged 0.51 percent in 2016. Since 2008, the expense ratios of target date mutual funds have fallen 24 percent.
- Average expense ratios for both actively managed and index equity mutual funds have fallen since 1996. In 2016, the average expense ratio of actively managed equity mutual funds fell to 0.82 percent, down from 1.08 percent in 1996. Index equity mutual fund expense ratios fell from 0.27 percent in 1996 to 0.09 percent in 2016. Investor interest in lower-cost equity mutual funds, both actively managed and indexed, has fueled this trend, as has asset growth and resulting economies of scale.
- Economies of scale and intense competition are putting downward pressure on expense ratios of exchange-traded funds (ETFs). In 2016, the expense ratios of index equity ETFs fell to 0.23 percent (down from 0.34 percent in 2009). Expense ratios of index bond ETFs, although down from a recent peak of 0.26 percent in 2013, were unchanged in 2016 at 0.20 percent.

The full report can be found at the following location: https://www.ici.org/pdf/per23-03.pdf

## WannaCry Ransomware Risk Alert

The SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a risk alert on May 17, 2017 regarding the global ransomware attack known as WannaCry. Windows systems infected by the WannaCry worm found their data encrypted and a ransom note on screen, demanding payment (usually in Bitcoin) for the encryption key.

The risk alert encouraged investment management firms and broker-dealers to review the alert published by the United States Department of Homeland Security's Computer Emergency Readiness team as well as evaluate whether applicable Microsoft patches to Windows operating systems were properly and timely installed. The OCIE recently completed the examination of 75 investment advisers, investment companies and broker-dealers to assess industry practices and issues surrounding cybersecurity preparedness. The WannaCry attack further strengthens the recommendations resulting from the OCIE's examination: 1) conduct a cyber-risk assessment to identify threats, vulnerabilities and business consequences; 2) perform penetration testing and vulnerability scans; and 3) ensure proper system maintenance.

## Investment Company Institute Releases White Paper on Medallion Signature Guarantees

Over the years, Medallion Signature Guarantees ("MSG") have become popular in the transfer agency industry to protect shareholders and investors, safeguard against fraudulent transactions, and limit the overall liability associated with transactions. The recent white paper published by the Investment Company Institute covers the history of MSGs, including the shifting landscape and reduction in the number of available guarantors. Also including the benefits of establishing MSG policies and procedures, applicability of using MSGs and other controls/alternatives available in lieu of MSGs. Further discussed was dollar threshold requirements, nonfinancial transactions (which is beyond the scope of the intended use of MSGs) and administrative concerns to take into account when evaluating the usage of MSGs.