# Industry Trends – May 2018

## Industry Statistics – Mutual Funds

| Fund Category | Net Assets (in billions) Mar-18 | Dec-17 | Percentage Change in Net Assets | Dollar Change in Net Assets (in billions) Total Change | Change Due to Net Cash Flows | Market |
|---|---|---|---|---|---|---|
| Stock | $10,280.0 | $10,305.8 | (0.3%) | ($25.8) | ($15.4) | ($10.4) |
| Hybrid | $1,497.9 | $1,525.8 | (1.8%) | ($27.9) | ($7.1) | ($20.8) |
| Taxable Bond | $3,424.2 | $3,401.9 | 0.7% | $22.3 | $48.3 | ($26.0) |
| Municipal Bond | $670.7 | $665.3 | 0.8% | $5.4 | $10.5 | ($5.1) |
| Money Market | $2,793.0 | $2,847.3 | (1.9)% | ($54.3) | ($61.2) | $6.9 |
| **Total** | $18,665.8 | $18,746.1 | (0.4%) | ($80.3) | ($24.9) | ($55.4) |

- **Stock** funds assets had a decrease during the quarter of $25.8 billion. For the quarter ended March 31, 2018, market depreciation was $10.4 billion compared to an appreciation of $511.2 billion for the quarter ending December 31, 2017. The net assets for stock funds decreased from $10,305.8 billion as of December 31, 2017 to $10,280.0 billion at the end of March, 2018.

- **Hybrid** fund assets decreased from $1,525.8 billion as of December 31, 2017 to $1,497.9 billion as of March 31, 2018. This compares to an increase of $35.9 billion in the fourth quarter of 2017. The increase was the result of market depreciation of $20.8 billion and net outflows of $7.1 billion.

- **Bond** funds had net inflows of $58.8 billion for the quarter ended March 31, 2018, compared to the previous quarter inflows of $58.2 billion. Assets for all bond funds increased $27.7 billion for the quarter ended March 31, 2018 which included, market depreciation of $31.1 billion.

- **Money market** funds had net outflows of $61.2 billion for the three months ended March 31, 2018, compared to the previous quarter inflows of $95.3 billion. Money market fund net assets, over the three month period decreased from $2,847.3 billion as of December 31, 2017 to $2,793.0 billion as of March 31, 2018.

Source: Investment Company Institute website

## REGULATORY UPDATE

### Closed-End Fund Receives No-Action Relief for Securities other than Common Stock

A closed-end fund recently received no-action relief from SEC staff that could have significant implications for closed-end funds' post-effective amendment filing processes. Currently, closed-end funds, other than interval funds, can only rely on Rule 486(b) for post-effective amendments if they obtain no-action or other relief. Absent this relief, any post-effective amendment must be reviewed by the SEC and subsequently declared effective, which can cause significant delay in the offering of a fund's shares. Interval funds are able to rely on Rule 486(b) to achieve immediate effectiveness so long as their updates relate only to fund financial statements or other non-material updates. Additionally, funds previously relying on certain exemptions from Rule 486(b) could only offer common stock.

In the no-action relief at issue, the Fund noted that it has registered, or may register, securities other than common stock. In this context, "securities" is defined to include the Fund's common stock, preferred stock, subscription rights, and debt securities. By extending the Rule 486(b) no-action relief to the Fund, the SEC paves the way for a broader set of funds to rely on Rule 486(b) effectiveness so long as they meet the other traditional requirements found in Rule 486(b) no-action relief letters.

### Investment Advisers Settle Claims Related to Failure to Disclose Conflicts of Interest Related to Securities Lending Activities

In March 2018, the SEC settled an enforcement action against Voya Investments, LLC and Directed Services, LLC in relation to the advisers' securities lending practices. The investment advisers managed insurance-dedicated mutual funds and the SEC alleged that the advisers engaged in the practice of recalling, in advance of dividend record dates, portfolio securities held by the funds from borrowers of such securities. This practice enabled the insurance companies that were affiliated with the investment advisers, and which were the record shareholders of such securities, to claim a "dividends received" deduction. This deduction was not available to the mutual funds. The SEC alleged that the advisers knew this practice benefitted the affiliated insurance companies but failed to disclose to the Board, after the Board's request for such information, that the funds were losing securities lending income as a result. For the relevant period it was alleged that the tax benefit to the affiliated insurance companies was over $2.6 million while the funds lost over $2 million of potential securities lending income. The SEC also alleged that because the advisers failed to disclose the practice of recalling securities in the funds' prospectuses that they failed to state a material fact in the prospectus and this omission made the other disclosures regarding securities lending materially misleading. The advisers agreed to pay disgorgement and interest of over $3.1 million and a $500,000 penalty.

## Share Class Matters

At the end of February, 2018, the SEC announced administrative cease-and-desist proceed–ings involving Ameriprise Financial Services, Inc. ("Ameriprise") and its sales practices with respect to share classes in certain open-end registered investment companies. From at least January 2010 through June 2015 Ameriprise disadvantaged certain retirement plan customers by failing to ascertain that they were eligible for a less expensive share class while selling them more expensive share classes. Ameriprise did so without disclosing that it would receive greater compensation from purchases of the more expense share classes. Accordingly, the SEC determined that Ameriprise willfully violated Sections 17 (a)(2) and 17 (a)(3) of the Securities Act of 1933, as amended. Ameriprise voluntarily identified those customer who purchased more expensive shares than those shares for which they were eligible and completed full remediation for those customers totaling $1,778,592.31. In addition to the remediation amount, the SEC imposed a civil penalty in the amount of $230,000.

In March of 2018, the Division of Enforcement (the "Division") of the SEC announced a Share Class Selection Disclosure Initiative ("SCSD Initiative") which is a new self-reporting program under which the Division is offering to recommend to the SEC standardized settlement terms for investment advisers that self-report failures to disclose conflicts of interest in connection with certain mutual fund share class selection practices.

In order to qualify for the SCSD Initiative, an adviser must have directly or indirectly received 12b-1 fees in connection with recommending 12b-1 fee-paying share classes for its clients when a lower-cost share class of the same fund was available to the clients. The SCSD Initiative is intended to incentivize advisers to self-report by offering standardized settlement terms. If a self-reporting adviser meets the program requirements and the Division pursues enforcement, the Division will recommend that the SEC accept an offer to settle which does not include a civil monetary penalty but does require the adviser to disgorge ill-gotten gains and pay pre-judgment interest to the impacted clients.

## SEC Preparing Rule Changes for ETFs

Speaking at the 2018 ICI Mutual Funds and Investment Management conference in March, Dalia Blass stated that the SEC's Division of Investment Management expects to present recommendations for a new ETF rule by the fall.  Blass, the Division's director, noted that the

$3.5 trillion ETF market operates under 300 individually issued exemptive orders, a state that she characterized as "not ideal for such an important segment of the asset management market." She noted that operating in this manner results in additional expense and uncertainty for participants in the ETF marketplace. Blass indicated that the ETF Rule may also address concerns in the area of ETF nomenclature, pointing out that the term "ETF" has evolved from a reference to a specific type of product to cover "investment companies with a wide range of strategies as well as a number of products that are not investment companies or even funds."

Blass also discussed the potential for the SEC to revisit the status of certain ETF index providers, including potentially requiring certain types of providers to register as investment advisers. She noted that index providers have historically relied on the "publisher's exclusion" from the definition of investment adviser. While the first ETFs involved relatively broad-based indexes (e.g., S&P 500), today ETF indexes have become more varied and customized. Blass questioned, "What should we make of an index that the provider maintains for one single fund...tak[ing] significant input from the fund's sponsor or board regarding the creation, composition or rebalancing of that index?" In such cases, Blass expects that SEC staff may require ETFs to explain why their index providers are not giving investment advice.

## SEC Letter Regarding Cryptocurrency

As reported in prior quarters UMBFS Industry Trends, the evolution of the cryptocurrency markets continues to be a hot topic for the investment industry and its regulators. Over the past six months, the SEC has occasionally commented on cryptocurrencies and their associated risks through various communication avenues with the public. More recently, Dalia Blass, the Director of the Division of Investment Management at the SEC released a letter responding to the investment industry's recent communications with the SEC on the topic. In her letter, she outlined some of the concerns and questions the SEC has relating to cryptocurrencies and encouraged an open dialogue among industry leaders.

First, Ms. Blass noted that cryptocurrencies raise a multitude of questions surrounding valuations for registered funds. She posed a variety of questions relating to fair valuation, lack of valuation information, valuation inconsistencies between the various types of cryptocurrencies and crypto-exchanges, as well as market misinformation and the potential for market manipulation. Next, Ms. Blass addressed questions related to liquidity of cryptocurrencies in registered funds. These questions related to both the assurance of liquidity as well as the classification of the various cryptocurrencies for the new fund liquidity rule. She concluded her letter by highlighting questions relating to cryptocurrency custody issues, ETF arbitrage concerns, and the overall risk of fraud and market manipulation in cryptocurrency markets.

Ultimately, the list of the SEC's concerns and questions demonstrates the significant hurdles facing those interested in incorporating cryptocurrencies into their investment products' portfolios. Ms. Blass invited responses to the SEC's concerns from the investment community and noted that until the SEC's concerns were addressed, she did not envision the SEC allowing a registered investment product to engage in cryptocurrency investing.

## Liquidity Rule Delays, Proposes Amendments and FAQs

On February 21, 2018, the SEC extended by six-months the deadline by which mutual funds must comply with certain elements of the Liquidity Risk Management Rule. The extension applies to the compliance date for portfolio classification and classifying highly liquid investments. The delay also impacts related items on Form N-PORT and N-Liquid. In addition, the SEC provided a six-month extension for board approval of the liquidity risk management program and annual review. Note that funds will still need to implement their liquidity risk management program as scheduled. (December 1, 2018 for larger fund groups and June 1, 2019 for smaller fund groups)

On March 14, 2018, the SEC proposed amendments to liquidity disclosure requirements for open-end mutual funds. The proposed amendments would:

- Eliminate the reporting and public disclosure of aggregated liquidity bucketing information. Under the current Rule, on a quarterly basis, funds would disclose the total percentage of the fund held in each of the four liquidity buckets. This information would be made public. Funds would still be required to report investment-specific bucketing information on Form N-PORT to the SEC on a monthly basis.
- Permit funds to split investment-specific bucketing information between the liquidity buckets. Under the current rule, each security could only be placed in one bucket. Based on security size and trading volume it makes sense that a single investment could be allocated across several buckets.
- Require funds to report on Form N-PORT cash and cash equivalents. These items were not required under the existing rule.
- Require funds to include liquidity specific disclosure in the annual report to shareholders. As part of the Management's Discussion of Fund Performance ("MDFP") a fund would have to briefly discuss the operation and effectiveness of the Fund's liquidity risk management program during the year.

These proposed amendments would become effective with the revised compliance dates approved earlier. June 1, 2019, for large entities and December 1, 2019, for smaller entities.

The SEC Staff recently released a series of responses to frequently asked questions regarding the liquidity risk management program ("FAQs"). The FAQs provide guidance on several issues, including:

- Clarify the role and relationship of the sub-advisors and the responsibility of the advisor to reconcile differences between sub-advisors in those situations.
- A complex's ability to classify the same investment differently in different funds. Should two or more sub-advisors classify the security inside of a fund, the advisor would have to reconcile those differences, however, with the proposed changes to the Liquidity Rule that would allow a single security to be split, this may no longer be necessary.
- Clarifies what is meant or required of "in-kind ETFs" where the liquidity rule requirements would not apply.
- Clarification of how changes in liquidity classification and meeting highly liquid minimums should be monitored intra-month. The Staff believes that a fund have in its policies and procedures a reasonable framework for identifying exceptions but does not require a fund to reclassify its existing investments on a daily basis and instead use the classifications last verified at the prior month-end.

The FAQ does provide important clarification on a number of issues that will assist advisors in managing their programs. The full FAQ can be found at:

https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq

## Supreme Court Ruling Narrows Whistleblower Protection for Internal Reporters

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") includes certain anti-retaliation protection for corporate whistleblowers who report potential violations of federal securities laws. Up until earlier this year, the federal courts of appeals were split on the extent of Dodd-Frank's protection for internal whistleblowers. In February 2018, the Supreme Court made a ruling that settled the divide and narrowed Dodd-Frank's protections. The Supreme Court found that Dodd-Frank's anti-retaliation protection only applies to corporate whistleblowers who report their claims directly to the SEC. Therefore, a corporate whistleblower who reports his or her claim internally – such as the individual in the case before the Supreme Court – is not protected by Dodd-Frank's whistleblower protections. The SEC was against this ruling as it feared that a limit in protections would deter corporate whistleblowers from reporting possible violations. It is important to note, however, that as this ruling only applies to claims brought under Dodd-Frank, claims brought under other regulatory provisions will keep their previous levels of anti-retaliation protection.

## Courts Rule in Investment Advisers' Favor in Three Recent Cases

In 2010, the U.S. Supreme Court cited the "Gartenberg factors" when assessing a Section 36(b) claim regarding fees paid to investment advisers. Since then, over 20 Section 36(b) cases have been filed throughout the country. A number of such cases have progressed through discovery to be tried on the merits. However, most recently, a federal district court in *Pirundini vs. J.P. Investment Mgt. Inc.* granted a motion to dismiss for failure to state a claim upon relief could be granted. This was the first dismissal for failure to state a Section 36(b) claim since the *Jones* decision. Also, in *Goodman v. J.P. Morgan Investment Management, Inc.* and *Zehrer v. Harbor Capital Advisors, Inc.*, after hearing the merits of the cases, two separate courts made full grants of summary judgment. In such cases the courts also applied the Gartenberg factors. These cases may be further evidence of the difficulty of prevailing on a Section 36(b) claim in light of the plaintiff's burden to show that a breach of fiduciary duty under Section 36(b) will be found only where the fee charged is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

## New York Stock Exchange to Pay $14 Million Penalty

The SEC recently announced that it has charged the New York Stock Exchange ("NYSE"), along with two affiliated exchanges, with regulatory failures, including several disruptive market events. This penalty encompasses the first-ever charged violation of Regulation SCI as it relates to violations of the business continuity and disaster recovery requirements. Per the SEC's order (the "Order"), the matter includes several episodes in which the NYSE and Exchanges engaged in certain business practices without having required and effective rules in place, operated in a manner that did not comply with the exchange rules in effect, and/or operated in a manner that did not comply with federal securities laws. The violations listed in the Order include, erroneously implementing a market-wide regulatory halt, negligently misrepresenting stock prices as automated, and applying price collars during unusual market volatility without a rule in effect to permit them. The SEC previously brought enforcement actions against the NYSE in 2014 for violating Sections 19(b)(1) and 19(g)(1) of the Securities Exchange Act of 1934.

The NYSE, NYSE Arca, and NYSE American have neither admitted nor denied the findings of the SEC's Order.

## Fifth Circuit Vacates DOL Fiduciary Rule, SEC Issues Own Rule Proposal

On March 15, 2018, the Fifth Circuit Court of Appeals issued a 2-1 decision vacating the Department of Labor's Fiduciary Rule, stating that the DOL exceeded its statutory authority in creating the rule. The rule, which took effect, in part, in June 2017 requires financial advisors to put their clients' best interests first when advising clients on retirement accounts. The court stated that the DOL acted unreasonably, arbitrarily and capriciously in expanding the long-standing definition of "investment advice fiduciary." The DOL did not seek an *en banc* re-hearing or appeal the ruling to the U.S. Supreme Court, effectively abandoning the rule. While the AARP and the attorneys general of three states (California, New York and Oregon) each submitted filings to the Fifth Circuit seeking a rehearing, such requests are rarely successful.

Meanwhile, the SEC proposed its own fiduciary rule in April that would require advisors to act in its clients' best interests "at the time a recommendation is made, without placing the financial or other interest of the broker-dealer or [an associated person] ahead of the interest of the retail customer." The so-called "Regulation Best Interest" proposal, which is somewhat less restrictive than the DOL's rule, is currently in a 90-day public comment period. The Regulation Best Interest Proposal can be found here: https://www.sec.gov/rules/proposed/2018/34-83062.pdf.

## Office of Compliance Inspections and Examinations Publishes 2018 Exam Priorities

The SEC's Office of Compliance Inspections and Examinations ("OCIE") has published its 2018 exam priorities. The priorities are broken down into five major categories: (1) Retail Investors, Including Seniors and Those Saving for Retirement; (2) Compliance and Risk in Critical Market Infrastructure; (3) Focus on FINRA and MSRB; (4) Cybersecurity; and (5) AML Programs.

*Retail investors, including seniors and those saving for retirement:* The SEC will particularly focus on retail investors saving for retirement and engage in examinations of firms providing products and services to them, which includes high risk products. The focus of these exams will be: (1) Disclosure of Costs of Investing; (2) Electronic Investment Advice; (3) Wrap Fee Programs; (4) Never-Before-Examined Investment Advisers; (5) Senior Investors and Retirement Accounts and Products; (6) Mutual Funds and Exchange Traded Funds; (7) Municipal Advisors and Underwriters; (8) Fixed Income Order Execution; and (9) Cryptocurrency, Initial Coin Offerings, Secondary Market Trading, and Blockchain.

*Compliance and Risks in Critical Market Infrastructure:* In this regard, the SEC will focus primarily on (1) Clearing Agencies; (2) National Securities Exchanges; (3) Transfer Agents; and (4) Regulation Systems Compliance and Integrity Entities.

*Focus on FINRA and MSRB:* With regard to FINRA, the SEC will focus on operations, regulatory programs, and the quality of FINRA's exams of broker-dealers and municipal advisors that are registered broker-dealers. With regard to MSRB, the SEC will evaluate the effectiveness of operational and internal policies, procedures and controls.

*Cybersecurity:* The SEC'S exams will continue to focus on governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

*AML Programs:* The SEC will be looking at whether entities are adapting their AML programs to address their obligations. Specifically, they will review customer due diligence, whether entities are filing timely, complete and accurate SARs, and whether entities are conducting robust and timely independent tests of their AML programs.

## FINRA 2018 Exam Priorities

On January 8, 2018, the Financial Industry Regulatory Authority ("FINRA") published its annual priorities letter highlighting the areas of focus for broker-dealer examinations this year. FINRA continues to pay particular attention to investment recommendations made to unsophisticated and vulnerable investors, including the elderly.

Similar to prior letters, the 2018 Letter identifies several reoccurring areas of concern, such as fraud and recidivist brokers. Six broad areas of focus are identified in the letter: Fraud; High-risk Firms and Brokers; Operational and Financial Risks; Sales Practice Risks; Market Integrity; and New Rules.

### Fraud

Fraud is always a major area of focus for FINRA. Fraudulent activities such as insider trading, microcap pump-and-dump schemes, issuer fraud, and Ponzi-type schemes harm investors and damage the integrity of the market. FINRA will continue to pursue investigations in these areas aggressively.

### High-risk Firms and Brokers

A top priority for FINRA will continue to be identifying high-risk firms and individual brokers and mitigating the potential risks that they can pose to investors. FINRA reminds firms of their existing obligation to adopt and implement tailored heightened supervisory procedures under FINRA Rule 3110 (Supervision) for high-risk individuals. FINRA will also continue to focus on the risks that these firms and brokers pose to investors, including unsophisticated or senior investors.

**Operational and Financial Risks**

Again this year, FINRA highlighted several areas of focus relating to operational and financial risks including business continuity planning, customer protection and verification of assets and liabilities, technology governance, cybersecurity, AML, liquidity risk, and short sales. Key priority areas include:

- Business Continuity Planning - FINRA will review how and under what circumstances firms activate their BCPs, and firms' plans for restoring systems, procedures, and records once they are prepared to resume normal business operations.
- Technology Governance - FINRA will review firms' information and technology change management policies and procedures. It is expected that FINRA will be focused on controls around changes to information technology, including end-to-end testing processes.
- Cybersecurity – several high-profile attacks occurred in the last year, which reinforced the need for broker-dealers to remain diligent in maintaining and improving their cybersecurity defenses. FINRA will evaluate the effectiveness of firms' cybersecurity programs, preparedness, technical defenses and resiliency measures.

**Sales Practice Risks**

Four areas of focus are highlighted: suitability, initial coin offerings ("ICOs") and Cryptocurrencies, use of margin, and Securities Backed Lines of Credit ("SBLOCs"). FINRA's added ICOs and cryptocurrencies for the first time in its annual letter.

Again, suitability is a returning area of focus. As the number and complexity of products available to investors continue to increase, FINRA will continue to assess the adequacy of firms' controls to meet their suitability obligations. FINRA will pay particular attention to suitability determinations in those situations where registered representatives recommend complex products to unsophisticated, vulnerable investors.

Digital assets (such as cryptocurrencies) and ICOs have received extensive attention in the past year. FINRA will closely monitor developments in this area, including the role firms and registered representatives may play in effecting transactions in such assets and ICOs. Where such assets are securities or where an ICO involves the offer and sale of securities, FINRA may review the mechanisms firms have put in place to ensure compliance with relevant federal securities laws and regulations and FINRA rules including business conduct, books and records, and know your customer.

**Market Integrity**

This year, eight areas of focus were announced which reflect FINRA's commitment to promoting market integrity in a manner that facilitates vibrant capital markets. They include manipulation, best execution, regulation SHO, fixed income data integrity, options, market access, alternative trading system surveillance, and report cards. FINRA continues to build new surveillance capabilities to detect market manipulation and is incorporating machine learning into new trade surveillance systems.

**New Rules**

Several significant new rules that have already or will become effective in 2018 include the following:

- Financial Exploitation of Specified Audits - FINRA Rule 2165 becomes effective February 5, 2018.
- Customer Account Information - Amendment to FINRA Rule 4512 becomes effective February 5, 2018.
- FinCEN Customer Due Diligence Rule (CCD Rule) - Firms must comply with this rule by May 11, 2018.
- Customer Confirmations - Amendment to FINRA Rule 2232 becomes effective May 14, 2018.
- Margin Requirements for Covered Agency Transactions - Amendment to FINRA Rule 4210 becomes effective June 25, 2018.
- Consolidated FINRA Registration Rules - FINRA Rules 1210-1240 become effective October 1, 2018.

## TAX UPDATE

***Regulatory***

### IRS Temporarily Suspends New Withholding Rules on Sales of Publicly Traded Partnerships

The IRS issued Notice 2018-08 announcing that the U.S. Department of Treasury (“Treasury”) and the IRS are suspending the application of the new Section 1446(f) of the Internal Revenue Code (“IRC”) in the case of a disposition of certain publicly traded partnership interests. The new Section 1446(f) was added by the Tax Cuts and Jobs Act (the “Act”), signed into law on December 22, 2017.

The Act also added a new Section 864(c)(8) which provides that a nonresident alien individual's or foreign corporation's gain or loss from the sale, exchange or other disposition of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent that the person would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value. New Section 864(c)(8) applies to sales, exchanges, or other dispositions occurring on or after November 27, 2017.

In general, the new section 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under the new Section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States (effectively connected gain), then the transferee must withhold a tax equal to 10 percent of the amount realized on the disposition. Under an exception in the new Section 1446(f)(2), however, withholding is generally not required if the transferor furnishes an affidavit to the transferee stating, among other things, that the transferor is not a foreign person.

The new Section 1446(f)(6) authorized the Secretary to issue such regulations or other guidance as may be necessary to carry out the purposes of the new Section 1446(f). The new Section 1446(f) applies to sales, exchanges, or other dispositions occurring after December 31, 2017.

In consideration of concerns raised by stakeholders, and to allow for an orderly implementation of the requirements of the new Section 1446(f), the Treasury and IRS have determined that withholding under the new Section 1446(f) should not be required with respect to any disposition of an interest in a publicly traded partnership until regulations or other guidance have been issued. This temporary suspension is limited to dispositions of interests that are publicly traded and does not extend to non-publicly traded interests. The Treasury and IRS intend to issue future regulations or other guidance on how to withhold, deposit, and report the tax withheld under the new Section 1446(f) with respect to a disposition of an interest in a publicly treated partnership. Future guidance under the new Section 1446(f) with respect to a disposition of an interest in a publicly traded partnership will be prospective and will include transition rules to allow sufficient time to prepare systems and processes for compliance.

## ICI Letter to Treasury Requesting Guidance on Application of New Interest Expense Limitation to RICs

The Investment Company Institute ("ICI") submitted a letter, dated March 1, 2018, to the U.S. Department of the Treasury ("Treasury") requesting clarification regarding, whether the amended Internal Revenue Code ("IRC") Section 163(j) pertaining to the limitation on business interest expense, amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (the Act), generally referred to as the Tax Cuts and Jobs Act, enacted December 22, 2017, applies to regulated investment companies (RICs), and if so, confirmation that (i) a RIC's interest income is properly allocable to the RIC's trade or business, (ii) adjusted taxable income includes all of the RIC's income and gains, and (iii) a RIC's adjusted taxable income for purposes of the new limitation is determined before application of the dividends paid deduction under IRC Section 561.

The Act amended IRC Section 163(j) and limits the deduction for net business interest expense to 30% of the taxpayer's adjusted taxable income. Adjusted taxable income is generally a business's taxable income computed without regard to (a) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business, (b) business interest or business interest income, (c) the amount of any net operating loss deduction, (d) the 20% deduction for certain passthrough income, and (e) for tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. Business interest is any interest paid or accrued on indebtedness allocable to a trade or business. Business interest does not include investment income.

## ICI Letter on Application of New Transition Tax to RICs

The Investment Company Institute ("ICI") submitted a letter, dated March 15, 2018, to the U.S. Department of the Treasury ("Treasury") and the IRS, indicating its concern and requesting guidance on the application to regulated investment companies ("RICs") of the new transition tax on deferred foreign income, as amended by the Tax Cuts and Jobs Act (the "Act"), enacted December 22, 2018. These rules generally require a U.S. shareholder (including a RIC) that own 10% or more of a foreign corporation to include as current income its pro rata share of the foreign corporation's post-1986 undistributed accumulated earnings and profits for its last taxable year beginning before January 1, 2018. The Act does not address how such amounts impact a RIC's qualification tests and distribution requirements or the application of the excise tax rules.

The ICI asks the Treasury and IRS to exercise the authority granted to them and (1) clarify that any deferred income be ignored or treated as qualifying income for purposes of the RIC income qualification requirements, (2) permit RICs to elect to include such income over the eight-year period available to other taxpayers for both income and excise tax purposes, thus spreading the required distribution of such amounts over the same period, (3) clarify that a RIC's share of deferred foreign income from a specified foreign corporation with a calendar year-end is treated as arising on January 1, 2018, for excise tax purposes, and thus is first included in excise tax calculations for 2018, not 2017, and (4) provide relief for all taxpayers in situations in which the foreign corporation will not or cannot provide information necessary for a RIC or other U.S. shareholder to determine its share of any deferred foreign income under U.S. tax principles.

## ICI Letter to Treasury and IRS on Proposed Mark-to-Market Election for Section 988 Transactions

The Investment Company Institute ("ICI") submitted a letter, dated March 20, 2018, to the U.S. Department of the Treasury ("Treasury") and the IRS supporting and requesting clarifications to the mark-to-market election provided for Internal Revenue Code ("IRC") Section 988 transactions in recently proposed regulations.

The ICI asks Treasury and IRS to clarify (1) the application of the netting rule of IRC Section 988 (b) and Treasury Regulation Section 1.988-2(b)(8) by including suggested examples, (2) that the straddle rules are inapplicable (or otherwise without effect) when a taxpayer that makes the mark-to-market election has one or more IRC Section 988 transactions that diminish currency risk on one or more other IRC Section 988 transactions, and (3) that the mark-to-market-election can be applied with respect to the full amount of IRC Section 988 gain or loss on all IRC Section 988 transactions held during or following the taxable year in which the mark-to-market election is made.

In addition, the ICI understands that the "Applicability Dates" section of the preamble to the proposed regulations to permit taxpayers to make the mark-to-market election for taxable years ending on or after December 19, 2017.

## FinCEN Extends FBAR Filing Deadline for Persons with Signing Authority

The United States Treasury Department's Financial Crimes Enforcement Network ("FinCEN") in FinCEN Notice 2017-1 announced a further extension of time for certain Report of Foreign Bank and Financial Accounts ("FBAR") filings, in light of the notice of proposed rulemaking ("NPRM") FinCEN issued on March 10, 2016 which proposed to revise the regulations implementing the Bank Secrecy Act regarding FBARs. Specifically, one of the proposed amendments would expand and clarify the exemptions for certain U.S. persons with signature or other authority over foreign financial accounts. This proposed amendment seeks to address questions raised regarding the filing requirement and its application to the individual with signature authority over, but not financial interest in, certain types of accounts as outlined in FinCEN Notice 2016-1.

On December 16, 2016, FinCEN issued Notice 2016-1 to extend the filing date for FinCEN Form 114 - FBAR for certain individuals with signature authority over but no financial interest in one or more foreign financial accounts to April 15, 2018. In the past five years, FinCEN has issued identical extensions that applied to similarly situated individuals. As noted in these previous Notices, FinCEN received questions that required additional consideration with respect to the exemptions addressed in these Notices. The proposed amendments in the NPRM seek to address these exemptions. Because the proposal is not yet finalized, FinCEN is further extending the filing due date to April 15, 2019, for individuals whose filing due date for reporting signature authority was previously extended by Notice 2016-1. This extension applies to the reporting of signature authority held during the 2017 calendar year, as well as all reporting deadlines extended by previous Notices 2016-1, 2015-1, 2014-1, 2013-1, 2012-1 and 2012-2, along with Notices 2011-1 and 2011-2.

***International***

## Germany - English Translation of FAQ on Status Certificate for Foreign Investment Funds

The German Federal Central Tax Office ("BZSt") has released an English translation of a FAQ addressing legal and formal questions regarding a Status Certificate. A Status Certificate must be obtained from the BZSt and is required to be provided, based upon the new German Investment Tax Law, effective January 1, 2018, to receive a reduced (15%) withholding tax on certain German income (e.g., dividends and capital gains).

## Korean Capital Gains Tax Proposal Withdrawn

The Korean Ministry of Strategy and Finance, on February 6, 2018, released a statement to the press withdrawing its proposal, previously issued, to lower the ownership threshold from 25 percent to 5 percent for taxing the capital gains realized by non-Korean investors on the stock of Korean listed companies on the Korean Exchange.

## ICI Global Letter to Swiss Government Proposing Procedures by Which US Funds Establish Treaty Eligibility

The Investment Company Institute ("ICI") Global has been engaged with the Swiss Ministry of Finance to ensure that U.S. funds taxed as regulated investment companies ("RICs") receive Swiss withholding tax relief as provided by the Switzerland-U.S. income tax convention. This led to the Swiss government announcing in September 2017, additional types of proof that they will accept for establishing the percentage of RIC shares held by U.S. persons.

The ICI Global sent a detailed submission, dated March 29, 2018, to Swiss Ministry of Finance, regarding additional methods of establishing the percentage of shares held by U.S. persons. The submission includes proposals and a proposed model letter that a RIC could use to supplement a tax reclaim filing and explain how it determined the U.S. tax residence of its investors.

## Indian Government Long-Term Capital Gain and Modification to Capital Gain and PAN Proposals

The Government of India's Finance Bill 2018, proposed to withdraw the exemption from income tax for long-term capital gains arising from the transfer of long term capital assets, and introduce a new section in the Income-tax Act 1961, vide a clause of the Finance Bill 2018, so as to provide that long-term capital gains arising from transfer of such long-term capital asset exceeding one lakh rupees will be taxed at a concessional rate of 10 percent.

On February 4, 2018, India's Central Board of Direct Taxes issued Frequently Asked Questions ("FAQs") regarding taxation of long-term capital gains proposed in Finance Bill, 2018-reg. The proposed new taxation regime imposing a 10% long term capital gains tax on non-resident taxpayers (including financial institutional investors ("FIIs") applies a tax to the transfer of long-term capital assets exceeding on lakh rupees. The FAQs clarify that (1) long-term capital assets include listed equity share, units of an equity oriented fund, and units of business trust that are held for a minimum of 12 months, (2) the cost of acquisition for assets equals the higher of (a) the actual cost or (b) the lower of (i) the FMV of the asset as of

January 31, 2018 or (ii) the consideration upon transfer of the asset, and (3) there will be no deduction at source from payment of long-term capital gains to a FII.

The Indian Finance Minister ("FM") introduced, on March 14, 2018, a modified Finance Bill in the Indian Parliament. The modified Finance Bill clarifies that the acquisition cost of long-term capital assets ("LTCAs") is stepped up even if a Foreign Portfolio Investor ("FPI") realized (i) an aggregate not long-term capital loss ("LTCL") in a assessment year, and (ii) an aggregate long term capital gain ("LTCG") in an assessment year but had adequate brought-forward tax losses that are available for set off fully against such LTGG.

The modified Finance Bill also clarifies that taxpayers will be able to step up acquisition cost for (i) unlisted shares as on January 31, 2018 that are subsequently listed, and (ii) listed shares (as on the date of transfer) received in consideration of unlisted shares as on January 31, 2018, pursuant to certain prescribed transactions.

Although the modified Finance Bill does not expressly clarify that FPIs are eligible for the acquisition cost step-up, it is understood that the Indian Government does not intend to discriminate between FPIs and other categories of taxpayers.

The modified Finance Bill limits the requirement to obtain a Permanent Account Number ("PAN") to key personnel associated with Indian tax resident entities.

***State***

## ICI Letter on Hawaiian REIT Tax Proposal

The Investment Company Institute ("ICI") submitted a letter, dated February 14, 2018, to Hawaii State Senator and Chair of the Hawaii Senate Committee on Ways and Means, Donovan M. Dela Cruz, indicating their opposition to Senate Bill (S.B.) No. 3067, because of its negative impact on shareholders in mutual funds that invest in real estate investment trusts ("REITs").

The legislation requires that REITs file returns reporting their shareholders' pro rata shares of net income and net income attributable to the State of Hawaii, and requires withholding on all payments to shareholders.

The ICI indicates that the proposal is not administrable and would lead to potential double taxation on mutual fund shareholders, specifically:

REITs cannot report accurate information regarding their individual investors

Over-withholding would occur

Fund investors would be harmed even if over-withholding did not occur

IRS Form 1099-DIV is not available to report withholding taxes imposed on the mutual fund

Because this legislative proposal would result in over-withholding by REITs and in double taxation on both Hawaiian and non-Hawaiian investors in mutual funds that invest in REITs subject to this tax, the ICI urged the State Senator and Hawaii Senate Committee on Ways and Means to reject it.

## California Legislative Proposal to Impose Services Tax

The Investment Company Institute ("ICI") submitted a letter, dated March 9, 2018, to California State Senator Robert M. Hertzberg, strongly opposing Senate Bill (SB) 993, introduced by Senator Hertzberg on February 5, 2018, proposing to impose a tax on the purchase of services by businesses in California.

The ICI indicates that any extension of sales tax to services purchased by these investment funds ("funds") and their managers in California would:

- impose additional costs on all (including Californian) investors seeking to save for their retirement and other long-term needs through these funds;
- be extraordinarily difficult (if not impossible) to administer efficiently and fairly; and
- place California-based firms operating in this nationwide industry at a competitive disadvantage;

If enacted, the sales tax must exempt services purchased by funds.

The ICI indicates that SB 993, as drafted, apparently would require asset managers to charge and remit sales tax on the investment advisory services provided to mutual funds to the extent such services are "appropriately apportioned" to California. The apportionment could be determined, presumably, based upon the location of either the fund manager or the fund's shareholders.

The ICI strongly recommends, on behalf of its California-based members and all California-resident shareholders, that sales tax not be extended to any services consumed within the mutual fund industry.