UMB Fund Services

Industry Trends – August 2020

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	
	June - 20	Mar - 20		Total Change	Net Cash Flows	Market
Stock	$10,609.4	$8,814.8	20.5%	$1,794.6	(133.3)	$1,927.9
Hybrid	$1,449.8	$1,304.4	11.1%	$145.4	($3.2)	$148.6
Taxable Bond	$3,911.1	$3,644.0	7.3%	$267.1	$89.6	$177.5
Municipal Bond	$805.7	$773.2	4.2%	$32.5	$13.2	$19.3
Money Market	$4,634.5	$4,337.4	6.8%	$297.1	$295.1	$2.0
Total	$21,410.5	$18,873.8	13.4%	$2,536.7	$261.4	$2,275.3

- Markets bounced back after the drop in March with **stock** fund assets increasing during the quarter 20.5% or $1,794.6 billion, compared to the drop of $2,561.4 in the first quarter. For the quarter ended June 30, 2020, market appreciation was $1,927.9 billion compared to a depreciation of $2,460.0 billion for the quarter ending March 31, 2020.

- **Hybrid** fund assets increased from $1,304.4 billion as of March 31, 2020 to $1,449.8 billion as of June 30, 2020. This compares to a decrease of $273.7 billion in the first quarter of 2020. The increase was the result of market appreciation of $148.6 billion and net outflows of $3.2 billion.

- **Bond** funds had net inflows of $102.8 billion for the quarter ended June 2020, compared to the previous quarter outflows of $185.3 billion. Assets for all bond funds increased $299.6 billion for the quarter ended June 30, 2020 which included, market appreciation of $196.8 billion.

- **Money market** funds had net inflows of $295.1 billion for the three months ended June 30, 2020, compared to the previous quarter inflows of $697.4 billion. Money market fund net assets, over for the three-month period, increased from $4,337.4 billion as of March 31, 2020 to $4,634.5 billion as of June 30, 2020.

Source: Investment Company Institute website

REGULATORY UPDATE

COVID 19 Update

As we enter our 2nd Quarter of operating under unique circumstances, the SEC has issued guidance to funds and investment advisors.
Maintained relief in a variety of areas:

- Proxy Material Delivery
- Conducting Shareholder Meetings
- Authentication and Retention Requirements
- TALF No-Action Letter (September 30, 2020)
- Short-Term Funding Flexibility for Mutual Funds and Separate Accounts
- In-Person Fund Board Meeting Requirements (December 31, 2020)
- Transfer Agent Relief
- Fingerprinting Requirements
- Paper Submissions, Manual Signatures, and Notarization Requirements
- EDGAR Filings (July 1, 2020)

Relief was not extended for:

- Prospectus Delivery to Existing Shareholders
- Transmittal of Annual and Semi-Annual Reports
- Form N-CEN and Form N-PORT Filing Deadlines

New relief was issued for:

- International Mail Service Suspensions

SEC Rule Requires Brokers to Stop Calling Themselves Advisors

The Rule, known as Regulation Best Interest (“Reg BI”), aims to reduce investors’ confusion around professionals who manage their personal finances. The issue concerns the difference between brokers and financial advisors.

Brokers conduct transactions such as stock trades for their clients. They’re allowed to recommend products that are suitable for an investor and which may also earn them the highest commission.

Conversely, a financial advisor has a fiduciary responsibility — a legal duty that requires an advisor to act in a client’s best interests — when making investment recommendations.

Because investment advisors are not paid by commissions for their investment recommendations – instead they are paid fees for their investment advice – advisors are considered to have no conflicts of interest with their clients.

Starting June 30, the SEC will require brokers and brokerage firms to stop using the term "advisor" in order to "enable a retail customer to more easily identify and understand their relationship."

The rule does not apply to individuals that are dually registered as both a broker and an investment advisor. Those individuals can essentially wear both hats – a broker and fiduciary financial advisor – with the same client.

SEC Approves Rule Changes to Allow Listing of ETFs on Exchanges

In April 2020, the SEC approved rule changes for the Nasdaq Stock Market LLC, Cboe BZX Exchange, Inc. and NYSE Arca, Inc. related to exchange-traded funds ("ETFs"). The new rules extend automatic listing to all ETFs that are eligible to rely on Rule 6c-11 under the Investment Company Act of 1940, as amended (the "1940 Act"). Rule 6c-11 of the 1940 Act was adopted by the SEC to remove for most ETFs the requirement to obtain or rely on individual exemptive orders from the SEC. These new rules for the exchanges will allow all eligible ETFs, whether index-based or actively managed, to qualify for listing and trading on an exchange both on an initial and continued basis by meeting and maintaining compliance with the criteria set forth in Rule 6c-11. ETFs that previously would have had to obtain individual exemptive orders under Rule 19b-4 because they did not satisfy the Exchange requirements for issuer size, liquidity or portfolio, e.g., would also be able to automatically list their shares if they comply with Rule 6c-11.

In order to meet the requirements of the new exchange rules, an ETF must, including among other things:

- Meet the requirements of Rule 6c-11(c) on an initial and continued listing basis;
- Have a minimum number of ETF shares outstanding at the time of commencement of trading on such exchange; and
- Have at least 50 beneficial holders of the ETF following the initial 12-month period after commencement of trading on such exchange.

Additionally, certain firewalls may need to be put into place between persons involved in the operation of the ETF.

It is expected that these new rules will be helpful in reducing the time and expense of bringing new ETFs to market.

SEC Adopts Changes to Reporting for Fund Acquisitions

The SEC recently adopted changes to the financial reporting requirements for investment company acquisitions of other investment companies.

The SEC has amended Rule 1-02(w) to create a separate definition of "significant subsidiary" tailored to investment companies. Specifically, new Rule 1-02(w)(2) includes an investment test and an income test to determine significance for investment companies.

- Under the investment test, a subsidiary would be considered significant if the value of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.
- The income test considers the absolute value of the income, and the gains and losses of the subsidiary in relation to the absolute value of the registrant's change in net assets from operations to test significance. Specifically, the subsidiary is significant if the absolute value of the sum of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary, for the most recently completed fiscal year exceeds:
- 80 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; or
- 10 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year and the investment test condition exceeds 5 percent ("alternate income test").
- Investment company registrants will now follow new Rule 6-11, rather than Rule 3-05, in the event that a fund acquisition occurs or is probable to occur. Rule 6-11 applies to the acquisition of a fund, including any investment company as defined in Section 3(a) of the Investment Company Act, any private fund that would be an investment company but for the exclusions in Sections 3(c)(1) or 3(c)(7), or any private account managed by an investment adviser.

The amendments eliminate the requirement to provide pro forma financial information for investment company registrants and substitute supplemental financial information intended to better inform fund investors about the combined company. The supplemental financial information consists of:

- A table showing the current fees for the registrant and the acquired fund and pro forma fees, if different, for the registrant after giving effect to the acquisition using the format prescribed in the appropriate registration statement;
- If the transaction will result in a material change in the acquired fund's investment portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to reflect such change and narrative disclosure describing the change; and
- Narrative disclosure about material differences in accounting policies of the acquired fund when compared to the registrant.

Registrants will not be required to apply the final amendments until the beginning of the registrant's fiscal year beginning after December 31, 2020. Acquisitions that are probable or consummated after December 31, 2020 must be evaluated for significance using final amendments. Voluntary early compliance is.

SEC Takes Action to Allow Closed-End Funds to Potentially Make Use of State Control Share Statutes

The SEC Staff recently acted to withdraw a prior no-action letter from 2010 which stated that a closed-end fund which relied on a state law control share statute would be in conflict with Section 18(i) of the Investment Company Act of 1940, as amended. Section 18(i) provides in relevant part that every share issued by a fund should have the same voting rights as every other outstanding share of fund stock. Control share statutes, which exist in almost half of the United States, generally prohibit a holder of "control shares" from voting their shares unless and until the voting rights are reestablished by the vote of disinterested shareholders. A holder of "control shares" is determined by the amount of shares owned and varies from state to state. Control share statutes may be an effective manner of limiting the influence of activist shareholders as it limits the ability of such shareholders to vote their shares but does not prevent them from voting because the disinterested shareholders may reinstate those voting rights.

When withdrawing the 2010 letter, the SEC Staff indicated that when choosing to opt into a control share statute, Boards will should act with "reasonable care on a basis consistent with other applicable duties and laws and the duty to the fund and its shareholders generally." The Staff also noted that such decisions would be reviewed based on the facts and circumstances at the time such decision was made. The SEC Staff in a footnote also noted in a footnote that it was making no comment on whether any other available measures, such as poison pills, may be inconsistent with Section 18(i) or any other provision of the 1940 Act.

SEC Shuts Down Fraudulent Investment Adviser Targeting Senior Citizens

The SEC announced on May 22, 2020, that it filed an emergency action to obtain a temporary restraining order and asset freeze against Northstar Communications, LLC, a California based registered investment adviser. The SEC's complaint alleges the investment adviser ran a Ponzi-like scheme, promising investors guaranteed interest payments if they invested in "private annuity contracts." These products were pitched during workshops and other events targeted at senior citizens. Northstar, and two other companies that it used to sell securities, eGate LLC and Planning Services, Inc., are charged with violating the antifraud provisions of the federal securities laws. The adviser raised approximately $5.6 million from at least 35 investors and paid out $5.2 million to investors as interest payments or returned principal. The SEC is seeking return of ill-gotten gains with interest as well as civil penalties.

Continued SEC Charges for KPMG Exam Sharing Misconduct

In mid-2019, KPMG LLP ("KPMG") agreed to settle charges with the SEC related to inappropriate sharing of both external audit request information and internal training exam answers among its associates. The firm settled the charges by paying the SEC a $50 million fine, agreeing to hire an independent consultant and ultimately enhancing its compliance policies and procedures. While the firm-related charges were settled in 2019, the SEC recently announced in May 2020 it settled charges with three now-former KPMG audit partners relating to both the exam misconduct and alleged attempts to cover up the misconduct during KPMG's internal investigations. As part of the settlement, each partner agreed to be suspended from practicing as an accountant before the SEC for a period of one to three years.

SEC Proposes New Rule on Fair Valuation

Recently, the SEC proposed rule 2a-5 that would provide the requirements for determining the fair value of a fund's investments. The Proposed Rule is intended to provide a consistent framework and standard of baseline practices for fair value.

Comments on the proposal were due by July 21, 2020.

The Proposed Rule would require the adoption and implementation of written fair value policies and procedures that are reasonably designed to achieve compliance with the requirements of the Proposed Rule.

The proposed rule has two main parts. The first establishes requirements for the determination of fair value in good faith. The second permits fund boards to assign the determination of fair value to the fund's investment adviser (or sub-adviser), subject to certain conditions and oversight.

The proposed rule requires Funds to establish procedures for the approval, monitoring, evaluation and oversight of pricing services. Considerations for the evaluations, include:

- qualifications, experience and history of the pricing service;
- valuation methods or techniques, inputs and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change;
- pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;
- pricing service's potential conflicts of interest and the steps the pricing service take to mitigate such conflicts; and
- testing processes used by the pricing service

Periodically testing the appropriateness and accuracy of any fair valuations and assessing any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest and managing those identified risks. Included, in the proposal, is a list of valuation risks that should be considered including:

- the types of investments held or intended to be held by the fund;
- potential market or sector shocks or dislocations;
- the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;
- the proportion of the fund's investments that are fair valued as determined in good faith and their contribution to the fund's return;
- reliance on service providers that have more limited expertise in relevant asset classes; the use of fair value methodologies that rely on inputs from third-party service providers; and the extent to which third party service providers rely on their own service providers (so-called "fourth party" risks); and
- the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

If the Board assigns the determination of fair valuation to the adviser, the Rule would require the board to oversee the adviser. The release states that oversight cannot be a passive activity. Instead, the board should view oversight as an iterative process in which they ask questions and seek relevant information, request follow-up information when appropriate, and take reasonable steps to see that matters identified are addressed. In particular, the proposal recommends the board should, among other things:

- identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts (e.g., those of the investment adviser and other service providers);
- periodically review the financial resources, technology, staff and expertise of the assigned adviser, and the reasonableness of the adviser's reliance on other fund service providers, relating to valuation;
- consider the adviser's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available to the CCO relating to fair value;
- consider the type, content and frequency of the reports they receive. While a board can reasonably rely on the information provided, it is incumbent on the board to request and review such information as may be necessary to be fully informed;
- inquire about material matters it becomes aware of and take reasonable steps to see that they are addressed;
- requires the investment adviser to provide periodic and, in certain circumstances, prompt reports to the board, at least quarterly, about its process for determining fair value. The proposal would also require reporting, in writing, to the board, within three days, on matters that could have a material impact on the fair valuation, including if a material weakness or significant deficiencies were identified.
- require the adviser to specify the titles of the persons responsible for determining the fair value of the investments, including specifying the particular functions for which the persons identified are responsible. It wozld also require the adviser to reasonably segregate the process of making fair value determinations from the portfolio management of the fund. The segregation requirement would not prevent portfolio managers from providing inputs into the fair value determination process.

The Proposed Rule would provide that a market quotation is readily available for purposes of section 2(a)(41) of the 1940 Act with respect to an investment only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable. This standard is drawn from ASC Topic 820. The Proposing Release also makes clear that evaluated prices, indications of interest, and accommodation quotes are not by themselves considered readily available market quotations.

If the Proposed Rule is adopted, the SEC would rescind two prior SEC releases, ASR 113 and ASR 118, and certain SEC staff letters and guidance relating to fair value determinations. The Proposing Release lists staff letters and guidance that would be withdrawn or rescinded, although it contemplates that other guidance might also be withdrawn or rescinded.

FINRA – Artificial Intelligence is Essential but Risks Abound

The Financial Industry Regulatory Authority (“FINRA”) recently issued a report regarding the existing and emerging uses of artificial intelligence (“AI”) by securities industry market participants. The report, *Artificial Intelligence (AI) in the Securities Industry*, reflects nearly two years’ worth of dialogue between FINRA’s Office of Financial Innovation and over two dozen market participants, including broker-dealers, academics, technology vendors, and service providers.

The report:

1. Briefly defines AI and specific technology in the securities industry
2. Provides an overview of AI usage by broker-dealers for communication with customers, investment processes, and operational functions
3. Discusses key challenges and potential regulatory considerations that broker-dealers may want to consider related to the use of AI

AI-based applications provide many benefits to broker-dealers in the security industry. Yet, broker-dealers should evaluate prior to implementation whether any potential inefficiencies exist with the application’s internal processes and whether its deployment would comply with all applicable law. Broker-dealers should review the report and carefully consider its discussion on the various business and regulatory implications. FINRA concluded by requesting comments including how FINRA can develop rules that support the adoption of AI applications in the securities industry in a manner that does not compromise investor protection and market integrity.

Private Fund Advisor Pays $1 Million for Advertising and Compliance Failures

The SEC announced that Old Ironsides Energy, LLC, a registered investment adviser based in Boston, Massachusetts, has agreed to pay a $1 million penalty to settle charges for failing to implement its own compliance policies and procedures regarding the distribution of marketing materials.

According to the SEC's administrative proceeding, Old Ironsides distributed marketing materials for a private fund called Old Ironsides Energy Fund II LP (“OIE Fund II”) from March 2014 to April 2015 which contained misleading statements relating to its historical performance for managing direct drilling investments. The marketing materials identified a large, legacy investment with strong, positive returns as part of its historical "Track Record" for early stage direct drilling investments. The SEC found that the marketing materials represented that Old Ironsides had direct management over this investment, when it was actually an investment in a private fund advised by a third party. Further, by including the private fund's performance, Old Ironsides' misleadingly improved its "Track Record" for these types of investments.

The preceding states that Old Ironsides had a regulatory compliance manual and code of ethics in place that included policies and procedures prohibiting “publishing, circulating or distributing any advertisement which contained any untrue statement or omission of a material fact or which was otherwise false or misleading”. The compliance manual further included policies and procedures that “prohibited the use of performance results in Old Ironsides’ marketing materials that were false or misleading, including any misleading depictions of investment performance in both form and content leading to direct or indirect implications or inferences arising out of the context of the marketing materials.”

The SEC's preceding finds that “Old Ironsides willfully violated Section 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-1 and 206(4)-7 thereunder”. Without admitting or denying the findings in the SEC's Order, Old Ironsides agreed to a cease-and-desist order, a censure, and a $1 million penalty.

SEC Secures Judgment Against Investment Adviser for Fraud and Breach of Fiduciary Duty

The SEC recently announced that it had obtained a final judgment and more than $30 million in monetary relief through an action brought against Navellier & Associates, Inc. (“Navellier”), and its founder and chief investment officer. The defendants were charged with breaching their fiduciary duties and defrauding their advisory clients and prospective clients through the use of marketing materials that included false and misleading statements regarding the past performance of one of the firm's investment strategies. The court held that the defendants violated the antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, as amended (the “IA Act”) and also found that the defendants knew there were misleading statements in their marketing materials and that there had been inadequate due diligence, but they also failed to inform their clients of these matters. The court determined that the defendants continued to sell the investment strategy despite the defendants’ knowledge that representations about the investment strategy were false and misleading. In addition to enjoining the defendants from violating Sections 206(1) and 206(2) of the IA Act, the final judgment also ordered the defendants jointly and severally to pay disgorgement of $28,964,571, including $6,513,619 in prejudgment interest, as well as civil penalties against Navellier in the amount of $2,000,000 and against Mr. Navellier in the amount of $500,000.

CFTC Proposes Revisions to CPO Reporting Requirements

The Commodity Futures Trading Commission has issued a proposal that would modify the periodic reporting requirements applicable to commodity pool operators ("CPO"s).

Comments on the proposal were due on or before June 15.

Currently, CPOs are required to file periodic reporting on Form CPO-PQR of information about a CPO and the pools that it operates. The form is composed of three separate schedules: Schedule A, which requires identifying information about a CPO, its pools, and service providers used; Schedule B, which requires detailed information about each pool, including a schedule of investments; and Schedule C, which requires greater detail about a CPO's pools, both on an aggregate and pool-by-pool basis (e.g., how the pool would respond to changes in market factors such as interest rates, credit spreads, currency rates, etc.).

The proposal would streamline the information to be reported on Form CPO-PQR and harmonize the frequency of reporting across all CPOs. It would eliminate the reporting requirements in existing Schedules B and C other than the pool schedule of investments and make certain other changes to existing Schedule A. As proposed to be revised, Form CPO-PQR would consist of:

- The information currently reported in Schedule A, except that questions seeking information about pool auditors and marketers would be deleted;
- The pool schedule of investments, currently required as part of Schedule B; and
- New questions to solicit legal entity identifiers (LEIs) for the CPO and its operated pools, but only to the extent that such entities already have LEIs.

Under the proposal, a CPO that is dually registered with the Securities and Exchange Commission as an investment adviser no longer would be permitted to satisfy its CFTC reporting obligation by filing Form PF.

The Department of Labor sends updated Fiduciary Rule to White House

The Department of Labor ("DOL") moved closer to a final so-called fiduciary rule. In early June, the DOL sent a revised fiduciary rule to the White House's Office of Management and Budget for that Office to either approve the publishing of the final rule or provide further comment. The DOL's original fiduciary rule was struck down by a court in 2018 with the court ruling that the DOL overstepped its authority beyond individuals the DOL regulates. The revised fiduciary rule is expected to be a more tailored version of its predecessor, but a final draft has not been released by the DOL.

DOL Proposes ESG Rule for Retirement Plans

In June 2020, the Department of Labor ("DOL") proposed a rule seeking to clarify its position with regard to environmental, social and government ("ESG") through retirement plans that operate under the Employee Retirement Income Security Act ("ERISA"), including 401(k) plans. In the proposal, the DOL states that it would be "unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-pecuniary goal." Under the proposed rule, fiduciaries must document the decision-making process when investing in ESG funds, justifying the investment "based on the purposes of the plan, diversification of investments and the interests of plan participants and beneficiaries in receiving benefits." Labor Secretary Eugene Scalia, in a Wall Street Journal op-ed noted that, "a fiduciary's duty is to retirees alone because under ERISA one 'social' goal trumps all others – retirement security of American workers."

DOL Guidance Allows Private Equity Exposure for ERISA Plans

On June 3, 2020, the U.S. Department of Labor ("DOL") issued an information letter allowing individual account plans covered by the Employee Retirement Income Security Act ("ERISA") to offer private equity investments though multi-asset class vehicles. The letter indicates that, subject to the plan, fiduciary evaluating and monitoring the risks and benefits associated with such investments, the selection of an investment with a private equity component would not violate the fiduciary's duties. As part of a fiduciary's review of investments containing private equities, "the fiduciary must engage in an objective, thorough, and analytical process that compares the fund with appropriate alternative funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component." While obtaining private equity exposure through multi-asset class vehicles structured as target date, target risk, or balanced funds is permitted, direct investment in private equities is not.

Adviser Settles Charges Related to Overvaluation of Odd-Lot Bond Positions

In April 2020, Semper Capital Management, L.P. ("Semper"), a registered investment adviser based in New York, agreed to pay $503,228 to settle charges that it misled investors about the performance of its Semper MBS Total Return Fund (SEMMX) mutual fund, a registered open-end investment company, and caused the overvaluation of certain of the fund's securities.

According to the order, Semper caused the overvaluation of smaller-sized bond positions known as "odd lots" purchased by the fund from July 2013 until May 2014. The overvaluation of odd lot positions was responsible for a substantial portion of the fund's performance during this period and resulted an overstatement of the fund's NAV. The order also states that the fund's 2013 and 2014 annual reports to investors, failed to disclose that the investment performance had been materially improved by the overvaluation of odd lot bond positions. Instead, Semper misleadingly attributed the performance to, among other things, Semper's purchase of non-agency mortgage backed securities that rose towards fundamental values during the periods in question. Without admitting or denying any wrongdoing, Semper agreed to a cease-and-desist order, a censure, and to pay disgorgement of fees totaling $103,228 plus interest of $25,000 and a $375,000 penalty.

US Bancorp Settles SEC's Share-Class Charges

In June, the registered adviser and broker-dealer division of US Bancorp, U.S. Bancorp Investments ("USBI"), agreed to settle share-class overbilling charges with the SEC for $16 million. The SEC's charges related to breaches of fiduciary duty related to USBI's mutual fund share-class selection practices. In an administrative proceeding, the SEC alleged that, from October 2012 through November 2017, USBI "purchased, recommended, and held for advisory clients mutual fund share classes that charged 12b-1 fees and shareholder servicing fees instead of lower-cost share classes of the same funds." According to the SEC, USBI retained the shareholder servicing fees and a portion of the 12b-1 fees without adequate disclosure of the conflict of interest. In 2017, USBI began converting investors into lower cost share classes and rebating 12b-1 fees. Under the settlement, USBI is paying disgorgement of $14 million and pre-judgment interest of $2 million. USBI neither admits nor denies the SEC's allegations. Similar fund share-class violations alleged by the SEC were settled with RBC Capital Markets and Cozad Asset Management in April 2020.

Financial Regulators Modify Volcker Rule

On June 25, 2020, federal regulators, including the Federal Reserve, Securities and Exchange Commission, Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., and Commodity Futures Trading Commission collectively finalized changes to the Volker Rule, easing restrictions on banks investing in or sponsoring hedge funds and private equity funds. Under the revised rule, firms without significant trading activities have streamlined compliance requirements while firms with significant trading activity have heightened compliance requirements. In addition, the revised rule excludes so-called "foreign excluded funds" from the prohibitions on proprietary trading and fund investments and relaxes the restrictions on assets that may be held by loan securitization vehicles.

The final rule is available at: https://www.sec.gov/rules/final/2020/bhca-9.pdf

TAX UPDATE

Regulatory

IRS Issues Elective Stock Dividend Relief for Publicly Offered RICs and REITs

The IRS issued Revenue Procedure 2020-19, which provides temporary guidance regarding the treatment of certain stock distributions by publicly offered regulated investment companies ("RIC"s) and publicly offered real estate investment trusts ("REIT"s). In recognition of the need for enhanced liquidity during the current period of economic disruption, the revenue procedure modifies the safe harbor provided previously in Revenue Procedure 2017-45, by temporarily reducing the minimum required aggregate amount of cash that distributee shareholders may receive to not less than 10 percent of the total distribution in order for §301 of the Internal Revenue Code, by reason of §305(b) of the Code, to apply to such distribution. The modification is effective solely with respect to distributions declared by a publicly offered RIC or publicly offered REIT on or after April 1, 2020 and on or before December 31, 2020.

Revenue Procedure 2017-45 provides a safe harbor for publicly offered RIC and publicly offered REITs that make a distribution to their shareholders with respect to their stock to ensure that such distributions of stock pursuant to a distribution in which each shareholder may elect to receive up to all of the shareholder's distribution in cash or stock of equivalent value are treated as distributions of property. If they conditions set forth in Revenue Procedure 2017-45 are met, the IRS will treat the stock distribution as a distribution of property and the value of the stock received by any shareholder in lieu of cash will be considered equal to the amount of cash which could have bee received instead.

Revenue Procedure 2017-45 requires that the cash limitation percentage be at least 20 percent. The cash limitation percentage is obtained by dividing the maximum aggregate amount of cash to be distributed to all shareholders by the amount of cash that would be distributed if each shareholder elected to receive solely cash under their respective stock-or-cash election. To enable a publicly offered RIC or a publicly offered REIT to conserve and thereby enhance their liquidity, Revenue Procedure 2020-19 temporarily allows such RIC or REIT to further limit the amount of cash available to be distributed to their shareholders by reducing the cash limitation percentage to 10 percent.

IRS Finalizes Regulations Permitting RICs to Pass Through Deduction for Qualified REIT Dividends

The IRS and the U.S. Treasury Department ("Treasury") has issues finalized regulations permitting regulated investment companies ("RIC"s) to pass through to shareholders "qualified real estate investment trust ("REIT") dividends received by the RIC. The pass through of qualified REIT dividends allows eligible shareholders to take advantage of the 20 percent deduction under Internal Revenue Code ("IRC") section 199A. The final regulations are adopted without substantive changes to the proposed regulations that were issued in 2019.

IRC section 199A was enacted on December 22, 2017 as part of the public law commonly referred to as the Tax Cuts and Jobs Act. IRC section 199A applies to taxable years beginning after 2017 and before 2026. Section 199A provides a deduction of up to 20 percent of qualified business income ("QBI") from a U.S. trade or business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate (a section 199A deduction).

Section 199A also provides individuals and some trust and estates, but not corporations, a deduction of up to 20 percent of their combined qualified REIT and qualified publicly traded partnership ("PTP") income, including qualified REIT dividends and qualified PTP income earned through passthrough entities.

The section 199A deduction is the lesser of (1) the sum of the combined QBI and qualified REIT and PTP components, or (2) an amount equal to 20 percent of the excess of the taxpayer's taxable income for taxable year over the taxpayer's net capital gain for the taxable year.

The final regulations provide guidance that allows a shareholder in a RIC to take a section 199A deduction with respect to certain income of, or distributions from, the RIC.