EY’s 10th Annual Mutual Fund Seminar

Advancing insight

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Program and presentation
We are delighted to welcome you to EY’s 10th Annual Mutual Fund Seminar in New York. This year’s event is video streamed, live from New York, to nine participating cities across the US: Baltimore, Cincinnati, Dallas, Minneapolis, Omaha, Philadelphia, Pittsburgh, San Antonio and Tysons. The seminar also takes place in two additional locations in June – Boston and Chicago. We are delighted to bring this seminar to you as part of our ongoing commitment to the industry and hope you find the discussions informative and insightful.

EY is dedicated to the mutual fund industry. Our Global Wealth & Asset Management sector is committed to offering industry insight and coordinating a network of more than 16,000 Wealth & Asset Management professionals who are ready to develop practical approaches to the assurance, advisory, tax and transactions issues you face. The current economic and regulatory environment is providing opportunities for the US mutual fund industry, promoting changes in product offerings and a rethinking of business strategy. Today’s challenges are expected to lead many fund complexes toward more cost-effective and more efficient operations.

For this year’s keynote address, we are honored to have Norm Champ, author and former Director of the Division of Investment Management at the U.S. Securities and Exchange Commission (SEC). Norm joined Kirkland & Ellis LLP Investment Funds Group as a partner in February 2016. We also have a team of distinguished panelists who will draw on their experiences to shed light on key developments in the industry. We will investigate how mutual funds are adapting to the evolving investor, regulatory and competitive landscape and share our thinking on what this means for the industry’s future. We hope you will find the discussion useful in dealing with the major challenges that mutual fund complexes face.

The objective of today’s event is to address burning issues from a macro perspective. Should you wish to discuss any of these issues in greater depth, please feel free to contact any of our panelists or your EY advisor.

A warm welcome to each of you – we hope you enjoy the 10th annual New York Mutual Fund Seminar.

Tom Flannery
Partner and Co-Leader, Americas Wealth & Asset Management
Ernst & Young LLP

Matt Forstenhausler
Partner and Leader, Registered Funds
Ernst & Young LLP

Rob Meiner
Partner and Leader, Registered Funds Tax
Ernst & Young LLP
Why EY?

EY provides services to:

- all of the top 10 US mutual fund companies
- 88% of the top 50 US mutual fund companies

EY’s Wealth & Asset Management practice is a market leader, providing services to 96% of the top 25 global asset managers

More than 1,000 executives attend EY’s Mutual Fund Seminar series across key US markets
Welcome to EY’s 10th Annual Mutual Fund Seminar in New York.

9:00 a.m.–9:10 a.m.  
**Welcoming remarks**  
Thomas Flannery, Partner, Financial Services Organization; Co-Leader of Americas Wealth & Asset Management Practice, Ernst & Young LLP

9:10 a.m.–9:40 a.m.  
**Keynote address**  
Introduction: Michael DiLecce, Partner, Financial Services Organization, Global and Americas Assurance Leader for the Wealth & Asset Management Practice, Ernst & Young LLP  
Norm Champ, Partner at Kirkland & Ellis LLP, author and former Director of the Division of Investment Management at the SEC

9:40 a.m.–10:35 a.m.  
**Trends in the digital agenda**  
Moderator: Ralph Mittl, Principal, Financial Services Organization, Ernst & Young LLP  
Panelists:  
• Scott Becchi, Principal, Financial Services Organization, Ernst & Young LLP  
• Dan Bender, Executive Director, Financial Services Organization, Ernst & Young LLP  
• Eric Jones, Senior Managing Director, Advisory Solutions and Product Development, TIAA  
• Brian Ward, Chief Risk Officer, Fidelity

10:35 a.m.–11:30 a.m.  
**Accounting and financial reporting update**  
Moderator: Chris Doyle, Partner, Financial Services Organization, Ernst & Young LLP  
Panelists:  
• Jaime Eichen, Partner, Financial Services Professional Practice Group, Ernst & Young LLP  
• Chuck Pulsfort, Director, BlackRock  
• Rick Sennett, Managing Director, Legg Mason

11:30 a.m.–12:25 p.m.  
**Tax update: tax reform and related RIC developments**  
Moderator: Rob Meiner, Partner, Financial Services Organization, Leader of Americas Registered Funds Tax Practice, Ernst & Young LLP  
Panelists:  
• Susan Curry, Managing Director, Legg Mason  
• Francis Grab, Principal, Washington Council EY

12:25 p.m.–12:30 p.m.  
**Closing remarks**  
Matt Forstenhausler, Partner, Financial Services Organization, Registered Funds Practice Leader, Ernst & Young LLP
Keynote speaker

Norm Champ
Partner at Kirkland & Ellis LLP, author and former Director of the Division of Investment Management at the SEC

Norm joined Kirkland & Ellis LLP Investment Funds Group as a partner in February 2016. He is the former Director of the Division of Investment Management at the SEC. Under his leadership, the SEC adopted a new rule in July 2014 to reform money market mutual funds.

Norm’s book, titled Going Public: My Adventures Inside the SEC and How to Prevent the Next Devastating Crisis, chronicles his experiences at the agency and how they shed light on the regulatory process and government policy-making.

Norm is also a lecturer on investment management at Harvard Law School. He began teaching in the fall of 2015, having just completed a term as Visiting Scholar. He is researching and writing on the regulatory response to the financial crisis.

While at the SEC, Norm led the creation of the Division’s Risk and Examination Office, which monitors the investment management industry to understand risks that regulations should address. He was the leader of the SEC’s interactions with the Financial Stability Oversight Council as the Council turned its attention to designating asset management firms as “systemically important.” He also worked on crisis management efforts at securities firms to protect customers of those firms. In addition, Norm headed the creation of Guidance Updates and Senior Level Engagement, initiatives created to provide transparency to the industry and to engage with boards and senior management of asset management firms, respectively. Norm also recommended that the Commission adopt the portion of the Volcker Rule covering private funds and other matters. For his service in the Division at the SEC, he received the Chairman’s Award for Law and Policy in 2014, the Chairman’s Award for Labor Management Relations in 2014 and the Chairman’s Analytical Methods Award in 2013.

Norm is on the Board of Directors of the School of American Ballet and a member of the Board of Trustees of The Spence School.

Norm has an AB, summa cum laude, in History from Princeton University; an MA in War Studies from King’s College London, where he was a Fulbright Scholar; and a JD, cum laude, from Harvard Law School.
Scott is a New York-based executive with more than 24 years of leadership, people management, strategy, planning, and systems implementation and outsourcing experience. He is focused in asset management, with extensive experience in all phases of the transformation life cycle, with a focus on large-scale transformations and systems integration/outsourcing project oversight, management and delivery. His roles on these engagements include program oversight, change management, architecture and communications. His specific skills include developing and implementing IT strategies, especially as they relate to achieving competitive advantage in business and managing cost. Scott is currently leading Ernst & Young LLP’s Asset Management Performance Improvement practice.

Prior to joining Ernst & Young LLP, Scott was a vice president at Capgemini, leading its Capital Markets/Asset Management practice. Before that, Scott spent 10 years at Andersen Consulting/Accenture as part of its systems integration practice.

Dan is an executive director in Ernst & Young LLP’s Wealth and Asset Management practice with more than 25 years of combined consulting and financial services industry experience advising asset management firms and fund sponsors on matters relating to operations and regulatory risk. Dan has extensive experience with enhancing the design, implementation and governance of core investment management processes, risk monitoring/
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**Susan Curry**
Managing Director
Legg Mason

Susan is a managing director in the Product Tax Group of Legg Mason, and assistant treasurer of the Legg Mason, ClearBridge and Western Asset funds. The Product Tax Group is primarily responsible for ensuring that the firm’s 1940 Act registered funds comply with the applicable tax diversification, distribution, reporting and filing requirements, in addition to providing tax advisory and support services to the Legg Mason investment affiliates. Before joining Legg Mason in 2004, Sue was a tax partner in the Investment Management Services Group of Deloitte, specializing in serving 1940 Act investment companies and investment partnerships. She is currently a member of the Investment Company Institute’s Tax Committee and Tax Advisory Group. Sue received her BS in Business Management and Marketing from Cornell University and her MBA in Accounting and Finance from the Johnson Graduate School of Management at Cornell University. She is a CPA licensed in New York.

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**Michael DiLecce**
Partner, Financial Services Organization
Global and Americas Assurance Leader for the Wealth & Asset Management Practice
Ernst & Young LLP
michael.dilecce@ey.com

Mike has more than 30 years of experience in the audit, financial reporting, regulatory and operational aspects of the asset management industry. His experience covers mutual funds, hedge funds and other investment funds, advisors and distributors. He has extensive experience with many types of investment fund products, including country-specific, tax exempt, international, real estate funds and exchange-traded funds. He has helped several asset managers launch their operations. Mike’s experience includes dealing with SEC compliance and reporting issues. He also has experience with domestic and offshore investment partnerships, as well as Global Investment Performance Standards compliance.

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**Christopher Doyle**
Partner, Financial Services Organization
Ernst & Young LLP
christopher.doyle@ey.com

Chris is a New York-based partner in the Financial Services Organization Assurance practice of Ernst & Young LLP. He has more than 15 years of experience in the financial services industry serving asset management clients. Chris focuses much of his time working with investment advisors; regulated investment companies, including exchange-traded funds; non-registered funds; and service providers.

Chris has a BA in Economics/Accounting from the College of the Holy Cross. He is a CPA licensed in Massachusetts and New York.
Our discussion leaders | New York

Jaime Eichen
Partner, Professional Practice Group
Ernst & Young LLP
jaime.eichen@ey.com

Jaime is a partner in Ernst & Young LLP’s Financial Services Organization. She has more than 18 years of experience in the asset management industry, including serving asset management clients such as mutual funds, SEC-registered and non-registered hedge funds, private equity funds, business development companies, investment advisors and general partners.

Prior to rejoining Ernst & Young LLP in 2014, Jaime was the Chief Accountant for the SEC’s Division of Investment Management for three and a half years where her responsibilities included directing the financial reporting, accounting and auditing practices of investment companies in compliance with the federal securities laws and discussing significant investment company accounting and auditing standard setting matters with the FASB and PCAOB. While at the SEC for nearly seven years, Jaime also worked closely with other divisions and offices within the SEC, including the Division of Enforcement, the Office of Compliance Inspections and Examinations, and the SEC’s Office of the Chief Accountant.

Thomas Flannery
Partner, Financial Services Organization
Co-Leader of Americas Wealth & Asset Management Practice
Ernst & Young LLP
thomas.flannery@ey.com

Tom is a partner in the Financial Services Organization of Ernst & Young LLP, and is the Co-Leader of the Americas Wealth & Asset Management practice. He has more than 35 years of experience at Ernst & Young LLP. Prior to his current role, Tom served as Location Leader for the Financial Services Organization in Boston, overseeing market activities for the banking and capital markets, asset management, hedge funds, private equity funds and insurance sectors.

Prior to that, Tom served as Ernst & Young LLP’s National Office Director of Quality for the Assurance and Advisory Business Services practice for the Americas, Americas Director of Audit Committee Communications and a member of the Audit Committee Leadership Network. Tom has an extensive client service background serving financial services organizations across various industries, including technology, manufacturing, retail and distribution. He has extensive public company and SOX 404 experience.

Matt Forstenhausler
Partner, Financial Services Organization
Registered Funds Practice Leader
Ernst & Young LLP
matt.forstenhausler@ey.com

Matt is the Registered Funds Practice Leader of Ernst & Young LLP’s Financial Services Organization. He has more than 30 years of experience and has been a partner since 1994. Matt has significant experience in the areas of registered investment companies (mutual funds, exchange-traded funds and business development companies), public investment advisors, private equity partnerships, hedge funds, broker-dealer and performance verification. He has assisted several operating companies in the IPO process and in complying with requirements of Sarbanes-Oxley. In addition to audits, Matt has been responsible for numerous internal control and compliance reviews for various investment advisory operations. He has performed due diligence reviews related to acquisitions of investment company advisors and operating companies.

Matt is a CPA and a member of the AICPA, as well as the Massachusetts, New Jersey and New York State Societies of CPAs. He chairs the Corporate and Social Responsibility Committee for Ernst & Young LLP’s Financial Services Organization.
Francis Grab
Principal
Washington Council EY
francis.grab@ey.com

Francis is a principal of the Washington Council EY practice where he advises clients on tax, budget and international trade issues. Prior to joining the firm, Francis served as the Tax and Trade Counsel for Representative Robert T. Matsui (D-CA), a senior member of the Committee on Ways and Means, for the 105th, 106th and 107th Congresses (1997-2002). In this capacity, he advised the congressman on tax, pension and trade policy matters. Francis was the Principal House Democratic Staff Contact for the successful effort to pass Permanent Normal Trade Relations for China in the 106th Congress. During the 105th Congress, he was the Trade Advisor to Mr. Matsui, who was then the ranking member of the Trade Subcommittee.

Francis served as the Chair of the Tax Policy Committee for the 2008 Obama Presidential campaign.

Francis received degrees from Swarthmore College and the Emory University School of Law. He also received an LLM in Taxation from the Georgetown University Law Center.

Eric Jones
Senior Managing Director,
Advisory Solutions and Product Development
TIAA

Eric leads TIAA’s retail advice and discretionary investment management capabilities. These teams are responsible for the advice and guidance provided to individual clients enterprise-wide (and supporting platforms and tools), as well as the investment strategy, asset allocation, securities research and portfolio management supporting TIAA’s discretionary advisory programs.

Collectively, Eric’s team is responsible for the tools and capabilities used by all TIAA channels to help clients understand what they can do to achieve their financial goals and then customizing and managing their assets to achieve the outcome they desire.

Prior to joining TIAA, Eric held a variety of senior wealth management, product management and investment research roles at UBS Financial Services.

Eric serves on the Board of Directors of Community Health Charities, a nonprofit organization representing many of the nation’s most trusted and recognized health charities. He is the coauthor of three books on the financial markets and trading: *Hedging Foreign Exchange*, *Mind Over Markets* and *Markets in Profile*. He holds a BS in Finance from Pennsylvania State University.

Robert Meiner
Partner, Financial Services Organization, Leader of Americas Registered Funds Tax Practice
Ernst & Young LLP
robert.meiner@ey.com

Rob is the leader of Ernst & Young LLP’s Registered Funds Tax practice. He has more than 27 years of experience in the financial services sector in both public accounting and private industry. He is involved with the coordination of the firm’s RIC practice national training development and instruction, and he has taught many training seminars for clients and internal staff members. Rob has authored tax-related publications specific to RIC and BDC tax issues. He has advised clients on the tax treatment of complex financial instruments, such as high-yield debt, contingent debt, inflation index bonds, emerging markets debt, derivative instruments, hedging strategies and foreign currency-related transactions.
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Ralph Mittl
Principal, Financial Services Organization
Ernst & Young LLP
ralph.mittl@ey.com

Ralph is a principal in Ernst & Young LLP’s Financial Services Organization and leads the Americas Wealth & Asset Management Risk and Regulatory practice. Based out of Washington, DC, Ralph works with an array of financial services and investment firms to build strong and effective compliance programs and remediates highly sensitive compliance matters. During an extensive career in regulatory compliance of nearly 20 years, his accomplishments have included leading investigations, presenting to the SEC, performing compliance due diligence for M&A and serving as CCO at one of the world’s largest private equity firms. Ralph focuses on helping investment advisors and investment companies, including private equity firms, hedge funds, endowments and mutual fund companies, to develop, assess and enhance their regulatory compliance programs.

His extensive experience and background includes assisting clients with internal and regulatory investigations, and significant knowledge and proficiency in forensic and analytical reviews of trading practices and compliance control failures. Ralph joined Ernst & Young LLP from Promontory Financial Group, where he led the Asset Management practice. Prior to Promontory, he formed Patomak Partners, where he was Managing Director and Co-Founder.

Chuck Pulsfort
Director
BlackRock

Chuck is a director in the Global Accounting Policy and Disclosure group at BlackRock. He has more than 14 years’ experience in the financial services industry.

At BlackRock, Chuck leads technical accounting and regulatory initiatives for the Americas, European and Asia-Pacific fund complexes. He also serves as a point person to address complex technical matters with industry groups and other standard setters.

Prior to joining BlackRock, Chuck was a senior manager at Ernst & Young LLP’s Financial Services Organization providing assurance and other services to wealth and asset management clients. He graduated from Ursinus College of Philadelphia with a Bachelor’s degree in Economics and Business Administration.

Rick Sennett
Managing Director
Legg Mason

Rick is a managing director and serves as the Principal Financial Officer for the US registered funds within the Legg Mason fund complex. Rick also leads the Treasury Policy and Valuation teams within Legg Mason’s Global Fiduciary Platform, which is responsible for preparing and filing fund financial statements, developing and maintaining accounting and disclosure policies, overseeing the daily portfolio valuation process and serving the fund boards. Rick is a member of the ICI Accounting-Treasurers Committee and has been a speaker at numerous industry conferences.

Rick has more than 23 years of experience in the asset management industry. Prior to joining Legg Mason, Rick was the Chief Accountant for the SEC’s Division of Investment Management. He served at the SEC for eight and a half years. Prior to working at the SEC, he led a number of departments within Deutsche Asset Management’s Global Fund Administration unit, including fund accounting and security valuation. Rick is a certified public accountant (inactive) and received his BBA in Accounting from Loyola University Maryland.
Brian is Senior Vice President, Corporate Risk Management for Fidelity Investments. Brian assumed his current role in January 2006 and is responsible for establishing the firm’s risk framework and standards, analyzing risk issues that transcend individual business units and working with business colleagues to find solutions, and reporting aggregate risk information to senior management.

Prior to this, Brian was Fidelity’s chief ethics officer responsible for overseeing the firm’s policy and program for the code of ethics, privacy and various other policies and programs, including the monitoring and surveillance operations for employee investing. Prior to this role, he held various positions in Corporate Audit where he was responsible for overseeing the audit plans for Fidelity’s outsourcing businesses, including retirement channels, Health & Welfare, Defined Benefit and HR Payroll services.

Prior to joining Fidelity in 1995, Brian was a senior audit supervisor with BayBank Inc. in Boston.

Brian received his Bachelor of Science degree in Finance from Providence College and an MBA from Suffolk University. He is a certified internal auditor and a chartered financial services auditor. He is a member of various risk management associations, as well as a member of the Ethics Officer Association and the Internal Auditor Association.
Panel discussions

Panel 1 – Trends in the digital agenda

Panel 2 – Accounting and financial reporting update

Panel 3 – Tax update: tax reform and related RIC developments

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Q&A

► Questions for the keynote
  ► If time allows, we’ll take your questions at the conclusion of the keynote address – there are mic runners in the audience
  ► Remote locations – submit questions via Skype

► Questions for the panels
  ► Please use the notecards on the table, and we’ll collect them during the sessions
  ► Remote locations – submit questions via Skype
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Keynote address: Norm Champ

Norm Champ
Partner at Kirkland & Ellis LLP, author and former Director of the Division of Investment Management at the SEC
Panel 1: Trends in the digital agenda

Ralph Mittl  
Principal  
Financial Services Organization  
Ernst & Young LLP  
ralph.mittl@ey.com

Eric Jones  
Senior Managing Director,  
Advisory Solutions and Product Development  
TIARA

Scott Becchi  
Principal  
Financial Services Organization  
Ernst & Young LLP  
scott.becchi@ey.com

Brian Ward  
Chief Risk Officer  
Fidelity

Dan Bender  
Executive Director  
Financial Services Organization  
Ernst & Young LLP  
daniel.bender@ey.com
Panel 2: Accounting and financial reporting update

Chris Doyle  
Partner, Financial Services Organization  
Ernst & Young LLP  
christopher.doyle@ey.com

Chuck Pulsfort  
Director  
BlackRock

Jaime Etchen  
Partner, Professional Practice Group  
Ernst & Young LLP  
jaime.etchen@ey.com

Rick Sennett  
Managing Director  
Legg Mason
Panel 2: Accounting and financial reporting update

- Accounting topics
  - Update on centrally cleared derivatives
  - Securities and Exchange Commission (SEC) update
    - Amendments to Regulation S-X
    - Investment company reporting modernization implementation matters
    - Liquidity risk management implementation matters
    - Financial statement comments
    - Rulemaking
  - Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2017-08, *Premium Amortization on Purchased Callable Debt Securities*
Update on centrally cleared derivatives
Variation margin

Overview
- The Chicago Mercantile Exchange (CME) and LCH Clearnet Limited (LCH) have amended their rulebooks to legally characterize variation margin payments for over-the-counter derivatives they clear as settlements against exposures rather than collateral against exposures.
- The revisions to the CME rulebook became effective on 3 January 2017.
- The changes to LCH's rulebook became effective in 2016.
  - For LCH, counterparties may elect whether (and when) to apply these amendments.
- Variation margin payments deemed to be legal settlements would now be considered a single unit of account with the derivative for accounting and presentation purposes.
- Prior to the changes, most registered funds accounted for gains and losses included in daily movements in variation margin on centrally cleared swaps as unrealized gains and losses on the income statement.
Update on centrally cleared derivatives
Variation margin

► Current developments
  ► The AICPA Investment Companies Expert Panel submitted a paper to the SEC staff addressing income statement presentation for funds

► Accounting considerations going forward
  ► View A
    ► Change in fair value of open settled-to-market derivative contracts may be accounted for as unrealized gains and losses until the contract delivery or termination date, at which point they would be reclassified to realized gains and losses
  ► View B
    ► Change in fair value of open settled-to-market derivative contracts may be accounted for as realized gains and losses when variation margin is transferred
      ► If a derivative contract is considered settled for balance sheet purposes, the cash flows that settle the change in fair value of the contracts should be recognized as realized gains or losses
Update on centrally cleared derivatives
Variation margin

► SEC staff’s views
   ► The SEC staff discussed its views at the ICI Mutual Funds and Investment Management Conference in March 2017
   ► The SEC staff would not object to either View A or View B provided the fund makes a policy election that is applied consistently to all centrally cleared derivatives for which transfer of variation margin is deemed legal settlement
   ► View A is consistent with the recent amendments to Regulation S-X and new Form N-PORT, which require disclosures that include unrealized appreciation/depreciation for investments in derivative contracts
Update on centrally cleared derivatives
Variation margin

- Other considerations
  - If a fund elects to change its historical accounting treatment, it would need to consider Accounting Standards Codification Topic (ASC) 250, Accounting Changes and Error Corrections
  - A fund would be required to obtain a letter from its independent auditor as required by Item 77L of SEC Form N-SAR (which will be replaced by Form N-CEN)
  - Balance sheet considerations for funds that use LCH and do not elect to change the characterization of their SwapClear contracts from collateralized-to-market to settled-to-market
  - Disclosures
SEC update
Amendments to Regulation S-X

Registered investment companies (RICs) and business development companies (BDCs) are subject to the new requirements, which include:

- Standardized schedules for open futures contracts, forward foreign currency contracts and swap contracts
  - Derivative schedules can no longer be included in the notes to the financial statements
- Additional disclosures for purchased and written options contracts
  - Description, counterparty (if not exchange-traded or centrally cleared) and notional amount
  - Written options rollforward no longer required
- Additional derivative disclosures
  - Net realized gain or loss and for each derivative type (income statement)
  - Net change in unrealized appreciation or depreciation for each derivative type (income statement)
  - Assets and liabilities related to each derivative type (balance sheet)
  - Identifying any derivative contract that cannot be sold due to restrictions or conditions applicable to the derivative
- Tax basis disclosures for a fund’s portfolio as a whole
  - Gross and net unrealized appreciation and depreciation
  - Aggregate cost basis for federal income tax purposes
SEC update
Amendments to Regulation S-X

- Additional schedule of investments disclosures
  - Indicating whether an investment's value was determined using significant unobservable (i.e., Level 3) inputs
  - Disclose when a portion of a security is on loan
  - Variable rate securities
    - Reference rate and spread
    - Disclosure of either (1) the end-of-period interest rate or (2) the referenced rate at the end of the period in a note to the schedule of investments
- Information for securities with payments in-kind
  - In-kind rate
  - Separately disclosing any payment-in-kind interest income or non-cash dividend income that exceeds 5% of a fund's total investment income (income statement)
- Affiliated investment disclosures
  - Net realized gain or loss and the net change in unrealized appreciation or depreciation on each affiliated investment held at the end of the period
- 144A securities – SEC clarification in adopting release footnote 669
  - 144A security is a restricted security if it has restrictions and cannot be sold to qualified institutional buyers
SEC update
Amendments to Regulation S-X

Custom basket options and swaps:

► Identification of the custom basket of securities or index if:
  1. The components are publicly available on a website at the balance sheet date
  or
  2. The components are not publicly available on a website at the balance sheet date and the contract’s notional amount doesn’t exceed 1% of the fund’s ending net asset value (NAV)

► Description of the custom basket of securities or index and list separately (including certain information about) (i) the 50 largest components of the basket or index and (ii) any other components where the notional value for that component exceeds 1% of the notional value of the basket or index if:
  1. The components are not publicly available on a website at the balance sheet date
  2. The contract’s notional amount is greater than 1% of the fund’s ending NAV

► Compliance date is for periods ending on or after 1 August 2017 (e.g., 31 August 2017 semiannual and annual reports)
  ► Early adoption is permitted, but funds have to adopt all amendments (e.g., cannot just remove written options rollforward and not implement other changes)

► Marked version of the amendments is available: [https://www.sec.gov/rules/final/2016/adopted-amendments-to-regulation-s-x.pdf](https://www.sec.gov/rules/final/2016/adopted-amendments-to-regulation-s-x.pdf)
SEC update

- Investment company reporting modernization implementation matters
- Liquidity risk management implementation matters
- Financial statement comments
- Rulemaking
FASB ASU 2017-08
Premium Amortization on Purchased Callable Debt Securities

▸ ASC 310-20 amendments
  ▸ Amends the amortization period for certain callable debt securities purchased at a premium
  ▸ Shortens the amortization period for the premium to the earliest call date
  ▸ If the call option is not exercised after the earliest call date, the effective yield is reset using the payment terms of the debt security
  ▸ Amendments do not require an accounting change for securities purchased at a discount; the discount would continue to be amortized to maturity

▸ ASC 946 amendments
  ▸ 946-320-35-20: premiums and discounts shall be amortized using the interest method. The amortization of premiums on purchased callable debt securities that have explicit, non-contingent call features that are callable at fixed prices on preset dates shall be consistent with the guidance in paragraph 310-20-35-33.
FASB ASU 2017-08
Premium Amortization on Purchased Callable Debt Securities

► Effective dates
  ► For public business entities: fiscal years and interim periods within those fiscal years beginning after 15 December 2018
  ► For all other entities: fiscal years beginning after 15 December 2019, and interim periods within those fiscal years beginning after 15 December 2020
  ► Early adoption: permitted for all entities, including adoption in an interim period
    ▶ If an entity early adopts in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year which includes that interim period

► Transition
  ► Modified retrospective basis, with cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption
  ► Disclosures shall be provided about a change in accounting principle in paragraphs 250-10-50-1 through 50-3 in the period of adoption
Panel 3: Tax update
Tax reform and related RIC developments

Robert Meiner
Partner, Financial Services Organization
Leader, Registered Funds Tax
Ernst & Young LLP
robert.meiner@ey.com

Francis Grab
Principal, Washington Council EY
francis.grab@ey.com

Susan Curry
Managing Director
Legg Mason
Evolution of the taxation of derivatives

- Various tax rules have evolved over time to prevent abusive use of financial transactions, generally including derivatives:
  - Small sample of current tax rules:
    - Dividend Equivalent Payments – §871(m)
    - Wash Sales – §1091
    - Straddles – §1092
    - Contracts Marked to Market – §1256
    - Conversion Transactions – §1258
    - Constructive Sales – §1259
    - Constructive Ownership – §1260
    - Swaps, Caps, and Floors – §1.446-3
    - Hedges – §§1.446-4 and 1.1221-2
- These rules are intended to prevent sophisticated taxpayers from using derivatives to defer income/gains, accelerate losses, or change character or source
- New rules are meant to simplify many of these rules and close gaps in the tax code that might currently be exploited
Modernization of Derivatives Tax Act (MODA)

- The proposed new rules will have four primary sections that will govern the taxation of derivatives and hedging transactions:
  - Section 491
    - Will govern the timing and character for the recognition of income/losses from derivative contracts and investments that are part of investment hedging units
  - Section 492
    - Will govern the taxability of investment hedging transactions, which will supersede current straddle and constructive sale rules
  - Sections 493 and 494
    - Provide for various definitions and coordination of new sections with other existing code sections
    - Derivatives are very broadly defined under Section 493
MODA – Section 493
Definition of derivative

Section 493

The term *derivative* means any contract (including any option, forward contract, futures contract, short position, swap or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

1) Any share of stock in a corporation
2) Any partnership or beneficial ownership interest in a partnership or trust
3) Any evidence of indebtedness
4) Any real property (with certain exceptions provided)
5) Any commodity that is actively traded (within the meaning of Section 1092(c)(4))
6) Any currency
7) Any rate, price, amount, index, formula or algorithm
8) Any other item as the Secretary may prescribe
MODA – Section 491
Taxation of derivatives

Section 491
- Generally provides new tax rules for the treatment of derivatives
- Gains and losses (with certain exceptions for losses) on derivative contracts and investments that are part of an investment hedging unit (IHU) are recognized upon a taxable event, which generally would include:
  1) The sale, transfer or termination of a derivative contract
  2) Upon the close of the taxable year, at which time the derivative will be treated as sold (i.e., marked-to-market)
     or
  3) The establishment of an IHU
- Any income, deduction, gain or loss recognized under Section 491 generally will be treated as ordinary income or loss
MODA – Section 492
Investment hedging units (IHUs)

► Section 492
► Provides for new general rules for the identification of hedging transactions
► If a taxpayer holds a derivative and underlying investment that have a “delta” between -.07 to -1.0, the transaction will be deemed to be an IHU
► Taxation
► On date IHU is established, gains, but not losses, on underlying investment are recognized for tax purposes
► Losses are deferred and not immediately recognized
► Gains will be treated as short or long capital gain assuming investment is capital asset
► If IHU is established, taxpayers will mark-to-market the derivative and the investment
► Gains and losses on the derivative and underlying investment once part of an IHU will be treated as ordinary income/loss
MODA – Section 492
Investment hedging units (IHUs)

- Section 492 (continued)
  - Taxpayers will be responsible for testing and identifying derivatives and underlying investments that both meet and do not meet the delta test
  - Taxpayers may make an irrevocable election to treat the derivative and underlying investment as being part of an IHU, in lieu of performing the delta test
  - If a taxpayer fails to perform the delta test, it will be treated as having made an election to treat the derivative and underlying investment as an IHU
  - Section 1092 straddle rules remain but will not apply to offsetting positions containing a derivative under Section 493
Issues for regulated investment companies (RICs)

► Potential for significant impact on ordinary income/loss
  ► Mark-to-market and realized gain/loss on all derivatives will be ordinary income/loss
  ► Mark-to-market and realized gain/loss on investments that are part of IHU will be ordinary
  ► Net operating losses (NOLs) would be carried forward
    ► Adds provision for a RIC to carry forward NOLs, like capital loss carryforwards (or NOLs for REITs)
  ► Monthly/quarterly distributing funds
    ► May face additional challenges in managing return of capital and Section 19b (multiple capital gains distribution) issues if large losses are recognized as ordinary

► Index funds that use short derivatives to hedge
  ► Would entire portfolio be deemed an IHU against short index future?
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A few parting words

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