August 1, 2015

AICPA Audit Risk Alert *Investment Companies Industry Developments:*

"SEC Staff Comments and Observations"

The following contains the "SEC Staff Comments and Observations" section, or comparable section, from each edition of the AICPA Audit Risk Alert Investment Companies Industry Developments from the 2008/2009 edition through the 2013/2014 edition, as compiled by the AICPA staff in August 2015. This content has not been modified since its original issuance, including paragraph numbers and references.

Please be advised that information included herein may have been superseded or revised since the issuance of this publication, or since the issuance of each original alert. Readers should remain aware of regulatory developments that have occurred since the original issuance of each alert, and this publication. For further information on current regulations and guidance provided by the SEC, see their website at www.sec.gov.

SEC Concerns

.25 Disclaimer: A summary of financial statement review comments issued by the SEC staff (the staff) to investment company registrants and other guidance related to issues encountered by SEC registrants follows. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

Fund Marketing Materials

.26 The staff expressed concern about instances when fund marketing materials on the registrant's Web site are not consistent with information submitted in SEC filings, such as registration or financial statements. In one instance, a closed-end fund had disclosed its distribution rate on its Web site without providing any explanatory context about its composition. This registrant had distributions that related to return of capital and capital gains in the year disclosed. In another instance, a registered fund disclosed expense ratios on its Web site that were calculated based on methods that were not consistent with the instructions provided in Form N-1A or Form N-2 (the forms) or generally accepted accounting principles (GAAP) requirements (for example, expense ratio was based on average total assets rather than average net assets or calculations excluded certain expenses, such as interest expense). Registrants should ensure that marketing materials on their Web sites are consistent with information included in SEC filings and that financial information disclosed is consistent with the forms and GAAP.

Disclosures of Credit Support in Financial Statements of Registered Money Market Funds

.27 A number of publicly available no-action letters have been issued over the past year relating to support agreements provided to MMFs that experienced asset deterioration. These letters describe the obligation of an affiliate to guarantee payment of any scheduled principal and interest payments that are not made, including the principal and final interest payment for a security or group of securities that a money market fund is holding. The guarantee may be supported by the sponsor by obtaining a letter of credit from a highly rated financial institution that has a credit rating comparable to other eligible money market investments, if the sponsor itself does not have such a rating. Additionally, the term of the agreements typically is limited to the maximum term permitted (397 days) for an eligible nongovernment security under Rule 2a-7, "Money Market Funds," under the Investment Company Act of 1940. Under such arrangements, MMFs bear no costs relating to the support agreements. The no-action letters can be accessed at www.sec.gov/divisions/investment/im-noaction.shtml#chron.

.28 Rule 2a-7 of the Investment Company Act of 1940 provides valuation guidance for registered MMFs. The rule places certain investment restrictions on MMFs that would minimize the impact of valuation volatility of their underlying asset portfolios. Accordingly, MMFs generally invest in short term investments, including certificates of deposit, commercial paper, and government securities and pay dividends to shareholders that generally reflect short-term interest rates. Although credit losses in the underlying portfolio of MMFs are possible, MMFs typically are managed with the goal of keeping losses to a minimum.

.29 Some MMFs sought to increase yields by investing in highly rated, short term debt tranches issued by structured investment vehicles (SIVs), which hold higher yielding securities. During the past year, events in the credit markets created situations in which the short term debt issued by certain SIVs could not be reissued due to concerns about some of the assets the SIVs held, causing buyers to be reluctant to purchase new paper. Additionally, in some cases, rating agencies downgraded SIV debt ratings due to asset concerns. The impact of these events left the SIVs in illiquid positions, and, in certain cases, the SIVs defaulted on their short term debt, resulting in further reductions in the market values of the SIVs' securities. In certain situations, market value decline became so significant that it potentially could have resulted in MMFs' noncompliance with Rule 2a-7 with respect to certain portfolio securities. Such noncompliance would have required MMFs to convert the valuation methodology followed for such portfolio securities from amortized cost to fair value, which would have caused the net asset value (NAV) per share to fluctuate from $1.00 and most likely fall below $1.00. To prevent the NAV from falling below $1.00, certain sponsors or investment advisors of MMFs intervened and provided some level of financial support to MMFs. This support included, but was not necessarily limited to, capital contributions, guarantees of value of specific investment securities (which may be supported through letters of credit), guarantees of principal of the overall funds, and agreements to purchase troubled securities at a value different than current market value (typically at amortized cost). The prospectuses of MMFs typically indicate that the shareholders in the MMFs are subject to the risk of loss of principal, and the sponsors or advisors of the MMFs do not commit, by contract or otherwise, to financially support the MMFs prior to the occurrence of any valuation event. The decision to provide additional financial support is made on a case-by-case basis when a specific MMF encounters difficulty.

.30 As a result of the credit crisis, during the later part of 2007 and throughout 2008, the SEC's Division of Investment Management staff received requests from MMF registrants for regulatory relief to the extent the MMFs' sponsors or advisors were willing to enter into financial arrangements with MMFs that were encountering valuation difficulties. In response, the SEC's Division of Investment Management staff issued several no-action letters. These no-action letters provided relief to certain MMFs and their sponsors or advisors for situations in which the sponsors or advisors, at no cost to the MMFs, agreed to provide support for the benefit of the MMFs. This relief occurred if specific MMFs' securities or identified group of securities ("security subject to credit support agreement") failed to pay principal or interest as due or to the extent the MMFs would be forced to sell the securities at a value less than amortized cost. The SEC's Division of Investment Management staff has required that credit support agreements, consistent with Rule 2a-7's maturity and quality requirements, have a short lifespan and that the credit support agreement providers either have a high credit standing or obtain a letter of credit from a financial institution with a high credit rating.

.31 To the extent an MMF receives some type of support agreement similar to those previously described, the MMF should present securities that are not subject to the credit support agreement(s) (and otherwise comply with the Rule 2a-7 guidelines) at amortized cost. Because the credit support agreement is considered to be a derivative, both the credit support agreement and the securities covered by it should be presented at fair value within the financial statements. Registrants should indicate, within the schedule of investments, which securities are subject to the agreement and that such securities are being carried at fair value. The existence and value of the credit support agreement should be identified separately on both the schedule of investments and the statement of assets and liabilities. Registrants also should refer to the note explaining the agreement.

.32 For the MMFs that have credit support agreements, the SEC staff noted that the fair value of the credit support agreement should offset the decline in fair value of those securities covered by the credit support agreement to ensure the MMF's shadow priced NAV does not fall below the minimum NAV specified in the credit support agreement. The SEC staff indicated that they would expect to see, in plain English, the following disclosures relating to credit support agreements:

- Date of the agreement
- Entities that are parties to the agreement (including clear identification of any affiliated parties)
- Objectives of the agreement
- Triggering events for payments stipulated in the agreement (for example, sale of the security or determination by a court that full repayment will not occur)
- Terms of "backstop" provisions (that is, provisions requiring, upon maturity of the agreement, that the MMF sell or otherwise dispose of the securities involved, triggering payment under the agreement)
- Specific securities subject to the credit support agreement and their fair value and amortized cost as of reporting date
- Date of termination of the credit support agreement
- Fair value of the credit support agreement at the reporting date
- Credit standing of the counterparty providing the credit support agreement (as noted, the expectation is that this counterparty will have high credit standing)
- Disclosure on the schedule of investments of which securities are carried at fair value (that is, not at amortized cost)
- Disclosure on the schedule of investments of nonincome producing securities and securities that made partial principal or interest payments

- Change in unrealized appreciation or depreciation for the securities subject to the credit support agreement (to be presented in the statement of operations)

- Change in unrealized appreciation or depreciation on the credit support agreement (to be presented as a separate line item on the statement of operations under the caption "change in unrealized appreciation(depreciation) from affiliates")

- Realized gain or loss, if any, relating to the credit support agreement (to be presented separately on the statement of operations)

.33 Payments received and credit enhancements provided through the credit support arrangements should be presented consistent with the guidance provided in chapter 7 of the 2008 AICPA Audit and Accounting Guide Investment Companies (2008 guide), including disclosure in the financial highlights of the effect on total return of the payment or credit enhancement.

.34 The staff indicated that many of the disclosure requirements previously described were derived from FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and FASB Statement No. 57, Related Party Disclosures. The staff also indicated that these disclosures should be placed in a separate, readily identifiable, easy-to-understand footnote to the financial statements and should not be placed within another note (such as a valuation policy or related party transactions note). MMFs should avoid copying language directly from the credit support agreement into the notes to the financial statements.

.35 Finally, the staff described additional disclosures that should be considered when an MMF holds securities affected by the credit crisis, even if not covered by a support agreement, no defaults exist, and NAV is not dramatically impaired:

- Disclosures about credit quality required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*

- Disclosures relating to risk concentrations of investments in the real estate or affected financial services industries (or in SIVs), as described in FASB Statement No. 107 and Statement of Position (SOP) 94-6, *Disclosure of Certain*

Significant Risks and Uncertainties (AICPA, *Technical Practice Aids*, ACC sec. 10,640)

.36 For more information, please refer to the AICPA Investment Companies Expert Panel meeting highlights posted on the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm.

Questions Relative to FASB Statement No. 157 and Form N-Q Disclosures

.37 The staff has questioned instances when registered investment companies (RICs) excluded disclosures required by FASB Statement No. 157 from their Form N-Q, "Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company," filings. The staff noted that it was appropriate to include all disclosures required by FASB Statement No. 157 that are applicable to interim reporting periods, including the required roll-forward of assets and liabilities valued using unobservable, Level 3 inputs when a registered investment company engages in a significant number of transactions in items valued using Level 3 inputs or holds a significant number of Level 3-valued investments throughout the reporting period. The staff indicated that Form N-Q refers to Rule 12b-20, "Additional Information," of the Securities and Exchange Act of 1934, which states that a registrant should include additional information to avoid making the schedule misleading.

Seed Financial Statements and Recoupment Plan

.38 The staff noted that a closed-end fund recently restated its seed financial statements because it failed to record a liability to the adviser under a recoupment plan. The staff stated that the note disclosure accompanying the seed financial statements indicated that the adviser will recoup organization costs after a specified period of time. Unlike traditional recoupment plans in which uncertainty exists about whether a fund's net assets will increase to a level that will permit repayment and not exceed a predefined expense cap, it was probable that the adviser would recoup fees from the fund after a specified period of time.

Business Development Company Accounting for Income Tax Expense

.39 The SEC staff noted that a business development company (BDC) restated its financial statements for improper accounting for income tax expense. Although the BDC elected to qualify under Subchapter M of the IRC, the BDC accrued a deferred tax liability related to the unrealized appreciation of portfolio securities. The deferred tax liability had been recorded by the BDC due to its perceived uncertainty surrounding the ability to maintain its qualification. Chapter 6 paragraph .04 of the 2008 guide states, "Income tax expense related to net investment income and net realized gains on investments should be recorded when it is probable that an investment company subject to Subchapter M of the IRC will not qualify under that subchapter. Management should consider the need for recording a deferred tax expense if management concludes it is probable that the investment company will not meet its qualification requirements for a period longer than one year." The SEC staff questioned whether the BDC should have recorded a deferred tax liability given the BDC's history of qualification under Subchapter M and its intent to continue to qualify under Subchapter M. The BDC ultimately concluded that the deferred tax liability was not appropriate and restated its financial statements to correct the error.

.40 The staff further noted an instance when one open-end fund chose not to comply with Subchapter M of the IRC and, therefore, elected to be taxed as a corporation. However, this registrant did not accrue any deferred tax liabilities on the net unrealized appreciation of portfolio securities, as required under FASB Statement No. 109, Accounting for Income Taxes. The registrant made a correction by recognizing the deferred tax liabilities, in accordance with FASB Statement No. 109.

SEC Comments and Observations

Disclaimer: The following comments represent the views of the accounting staff of the SEC's Division of Investment Management and do not necessarily reflect the views of the commission or other members on the commission's staff. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

Mergers and Liquidation

.59 The SEC staff has noted an increase in fund mergers and liquidations based on the frequency of questions and N-14 filings received by the SEC staff. The staff expressed concern that some registrants may be attempting to merge away funds with historically poor performance into funds with little or no performance history. Registrants are reminded to look to the 1994 North American Security Trust no-action letter for guidance on evaluating which entity would be deemed the accounting survivor of the fund merger. The evaluation includes consideration of the investment adviser, fund size, fund composition, fund strategy, and expense arrangements, among other things. A registrant should weigh all of these factors in order to conclude upon the accounting survivor.

.60 Where differences in procedures and policies between funds participating in a merger exist (for example, valuation procedures and accounting policies) that will result in changes affecting investors, disclosures in the proxy statements should detail the changes and how the changes will affect investors going forward. Subsequent financial statement disclosures would only need to convey the current accounting policies and procedures of the surviving fund.

.61 During fund mergers, most registrants look to utilize Rule 488 of the Securities Act of 1933, "Effective Date of Registration Statements Relating to Securities to Be Issued in

Certain Business Combination Transactions," (Rule 488) which provides automatic effectiveness to a registration statement filed on Form N-14 30 days after the date of such filing. Rule 488 requires the registration statement to be materially accurate and complete. A material omission of required financial information (for example, pro-forma financial statements, audited financial statements, or auditor consents) would cause the registration statement not to qualify for 30 day automatic effectiveness under Rule 488.

.62 The SEC staff reminded registrants that 11-02(b) of Regulation S-X, "Form and content," permits registrants to provide a narrative description of the pro-forma effects of the merger instead of providing pro-forma financial statements, when there are a limited number of pro-forma adjustments and the pro-forma adjustments are easily understood.

.63 The SEC staff also reminded registrants that when funds bear the costs associated with mergers, the pro-forma capitalization table should be adjusted to reflect the costs and the statement of assets and liabilities should reflect the costs as a pro-forma adjustment. The statement of operations should not reflect these costs as a pro-forma adjustment because such costs are nonrecurring.

.64 The SEC staff provided guidance for the presentation of pro-forma fee tables and capitalization tables in N-14 filings for registrants contemplating multiple mergers. Multiple mergers occur when three or more funds merge and the merger is not contingent upon shareholders of each fund approving the merger. In the pro-forma fee table, the SEC staff would not object if registrants disclose a range of possible expense ratios, which would include the highest and lowest expense ratio and the expense ratio that would be incurred if all funds merged. In the pro-forma capitalization table, the SEC staff would not object if registrants disclose the same combinations as disclosed in the pro-forma fee table or the most likely combination. The SEC staff also cited the 1995 "Dear CFO" letter, which allows registrants to present one set of pro-forma financial statements reflecting the combination of all funds involved in the proposed merger.

.65 Registrants should be aware of Article 3-18 of Regulation S-X, "Special Provisions as to Registered Management Investment Companies and Companies Required to Be Registered as Management Investment Companies," which requires financial statements included in filings to be current (within 245 days of the effective date of the filing). If the date of the financial statements exceeds 245 days of the effective filing date, the registrant needs to include additional unaudited information.

Distressed Securities

.66 Management has the duty to look for and assess information relating to distressed securities. As such, management should have an appropriate process in place to monitor the market, identify troubled securities, and react timely by taking appropriate write-downs or ceasing interest accruals. Registrants should look to Article 12 of Regulation S-X, Form and Content of Schedules, for guidance on required disclosures relating to nonincome producing securities. For example, if the security has defaulted on interest payments, it should be flagged in the schedule of investments as a nonincome producing security. If there has been a partial interest payment, such information should also be flagged or disclosed by the fund.

.67 Registrants can also look to the 1994 "Dear CFO" letter that provides guidance on how a security should be disclosed in the schedule of investments when it has been written down to zero. A security should be removed from the schedule only after the fund has identified the security as worthless for federal income tax purposes. Omitting securities from the schedule prior to the determination of worthlessness for tax purposes may be misleading to investors interested in evaluating the fund's investments.

Securities Lending

.68 An area of increased SEC staff scrutiny is securities lending, specifically as it relates to how the fair value of investments made with cash collateral received in connection with securities lending transactions were determined prior to the height of the credit crisis in September 2008. Many registrants used cash collateral to purchase pooled investment vehicles (PIVs) that were similar to Rule 2a-7 money market mutual funds, although these funds were not registered under the Investment Company Act of 1940. These pools typically held investments with lower credit quality and longer maturities than permitted by Rule 2a-7. As a result, the valuations of the securities in these investment pools were more volatile than the valuations of securities held in money market funds complying with Rule 2a-7, and in some instances, the collateral pool's NAV per share based on market values dropped below $1 per share. Addressing concerns about overall collateral pool liquidity, securities lending agents continued to process shareholder transactions at $1 per share, but placed restrictions regarding how investors would be redeemed out of these investment pools. In some cases, funds requesting redemptions over certain thresholds or electing to withdraw from the securities lending program altogether, would be paid in-kind (that is, not in cash) in order to help regulate decreased pool liquidity levels. Some registrants, despite the decrease in value and liquidity of the securities that made up the pool, continued to value these collateral pool investments at $1 per share until the fourth quarter of 2008. Given that many of these investment pools' market values declined below $1 per share much earlier than the fourth quarter of 2008, coupled with the redemption restrictions, the SEC staff is questioning whether write-downs should have been taken prior to the fourth quarter of 2008.

.69 The SEC staff indicated that, in some cases, it was apparent that registrants did not have appropriate policies and procedures in place to monitor the valuation of securities that were acquired with cash collateral received in conjunction with securities lending transactions. The SEC staff stated that registrants are responsible for the fair value determination of cash collateral investments.

.70 The SEC staff expressed concern over some disclosures they have seen in recent filings. These disclosures were either unclear or lacking altogether. For example, the SEC staff noted that the disclosures in financial statements should convey whether losses have actually been incurred during the reporting period rather than stating that losses may be incurred. Disclosures in the accounting policy footnotes for some funds mentioned that investments of cash collateral received in connection with securities lending programs may decline in value, when in fact the values did decline. If losses were incurred, it should be clearly communicated in the footnotes of the financial statements.

Fulcrum Fees Under Rule 205-2(c) of the Investment Advisers Act of 1940

.71 The SEC staff has noted some advisers are switching to the use of fulcrum fees as compensation for their advisory services provided to mutual funds. Fulcrum fees are performance based fees in which advisers to mutual funds are compensated depending on how well their managed fund performed relative to a particular benchmark. The fulcrum fee is made up of two components—the base fee (also referenced as the "fulcrum fee" in Rule 205-2(c) of the Investment Advisers Act of 1940, "Definition of 'specified period' Over Which the Asset Value of the Company or Fund under Management is Averaged"), which represents the midpoint of the entire fulcrum fee, and the incentive adjustment. Generally, the adviser is paid the base fee if the fund's performance matches the performance of the benchmark. If the fund outperforms its benchmark, the adviser receives an incentive payment in addition to the base fee. Conversely, if the fund underperforms its benchmark, the adviser is penalized and the base fee is reduced by a negative incentive adjustment.

When calculating payments to advisers under a fulcrum fee arrangement, the incentive portion of the fee is required to be calculated using the average net assets over the rolling performance measurement period. However, when calculating the base portion of the fulcrum fee, funds have the option to either apply the base rate to average net assets over the rolling performance measurement period or apply the base rate to current level average net assets (or as Rule 205-2(c)(2) states, "asset value averaged over the most recent subperiod," - which represents the period between payments). Whichever option is approved by the fund's board, it must be applied consistently. In recent months, some funds switching to a fulcrum fee arrangement are opting to rely on Rule 205-2(c). Fulcrum fee arrangements pursuant to Rule 205-2(c) may result in the adviser reimbursing the fund. This situation can occur when there is a significant decline in assets coupled with poor performance because the negative performance adjustment, when translated from a percentage to dollars, exceeds the base fee. In this scenario, the base portion of the fee is calculated on current level net assets that are much lower than average net assets over the rolling performance measurement period. When funds rely on Rule 205-2(c)(2) to calculate the base portion of the fulcrum fee, the SEC staff is reviewing the disclosure describing the terms of the advisory fee agreement and looking for specific disclosure stating that the adviser will reimburse the fund when the negative incentive adjustment exceeds the base fee.

.72 In addition, the SEC staff has observed instances when advisers have attempted to limit the incentive adjustment to a multiple of the base fee (for example, the incentive adjustment cannot exceed two times the base fee). The SEC staff has objected to these adjustments because it results in the incentive adjustment being tied to current level net assets rather than the average net assets over the rolling measurement period. Also, the SEC staff has objected to other fulcrum fee arrangements when the maximum negative incentive adjustment was less than the maximum positive incentive adjustment.

Expense Recapture Plans

.73 In an expense recapture plan, the adviser and the fund enter into an agreement whereby the adviser can recapture expenses waived in prior years to the extent that the fund achieves economies of scale relevant to the established expense cap. The SEC staff has seen instances where funds instituted a cap in the first year of operations and then increased the cap in subsequent years above the current expense ratio. The SEC staff reminds registrants that they cannot begin to recapture prior year expenses incurred under previous expense cap arrangements solely because of an increase in the current year's expense cap. Prior year expenses can be recaptured only if the current expense ratio is less than the prior year expense cap that was in place when such prior year expenses were waived.

Multiclass Presentation

.74 Most funds disclose the class-specific amounts for expenses and distributions on the face of the statement of operations or statement of changes in net assets, respectively. Due to increases in the number of classes offered by some funds, the statements of operations and changes in net assets can be cluttered. The SEC staff indicated that they would not object if a fund presents aggregate amounts (for example, total 12b-1 fees or total distributions) in the financial statements and the class-specific amounts within the accompanying notes to the financial statements.

Financial Reporting

.75 The SEC staff has observed instances where counterparties to derivative instruments and interest rates on particular debt securities have not been identified in the financial statements. Registrants should look to Article 12 of Regulation S-X for required disclosures for each investment in the schedule of investments. The SEC staff indicated that the identification of the counterparty is a material component of a security's description since a fund is exposed to the risk of nonperformance by a counterparty. The SEC staff also expects to see disclosure relating to counterparty risk because it is an important part of the overall financial statement disclosure requirements.

.76 The SEC staff noted two types of payments from affiliates, as defined in the Audit and Accounting Guide Investment Companies (the guide): (a) to reimburse the effect of a loss (realized and unrealized) on a portfolio investment, often the result of circumstances outside the fund's, or its affiliates' control, such as an issuer default, and (b) to make the fund whole relative to a realized loss on a portfolio investment made by the fund's adviser in violation of the fund's investment restrictions. The guide requires the fund to state these payments from affiliates separately in the statement of operations as a realized gain, provide a description of the reason for the payments in the notes to the financial statements, and disclose the impact of the payments on the fund's total return in the financial highlights. The SEC staff noted that the fund may receive other payments from affiliates for other reasons. An evaluation must be made to determine whether to disclose the payments on the statement of operations or the statement of changes in net assets. Regardless of the type of payment received, the fund should separately disclose the payments received in the respective financial statement, show the impact on the total return relating to such items in the financial highlights, and provide narrative disclosure of the reasons why such payments were made.

Enforcement—Valuation

.77 The SEC staff highlights two recent enforcement actions relating to valuation in order to remind registrants about the importance of communicating valuation information to the board. The first enforcement action is a complaint against an adviser to a business development company (BDC). The SEC alleged that from 2002 to 2005, the adviser substantially overstated the values of two specific private investments that accounted for more than half of the investment portfolio of the BDC in order to generate higher advisory fee income. Management allegedly had material information relating to the valuation of the private investments that could adversely affect their fair values; however, management allegedly did not share that information with the board of directors, the independent auditors, or the investors. The full text of the SEC's complaint is available at www.sec.gov/litigation/complaints/2009/comp21178.pdf.

.78 The second enforcement action was against an adviser to a mutual fund. The SEC alleged that management of the fund disclosed to a select group of shareholders the reasons and the likelihood that some of its securities may have to be repriced, which gave these shareholders privileged information over others. Therefore, the informed shareholders would have had the opportunity to cash out their investments in the mutual fund before the fund's NAV declined even further. The SEC also alleged that management did not take into account certain readily available information about the subprime residential mortgage market when valuing its mortgage-backed securities. Management also did not factor in widely reported data about the weakening of an index that had served as a benchmark used to measure risk of a particular mortgage-backed security. In addition, management continued to override lower vendor quotes on some of the funds' investments using higher single quotes from various broker-dealers, one which had a pricing methodology that had been neither reviewed nor approved by the valuation committee. The fund's board adopted a three-tiered valuation system where the first and most preferred valuation method was the use of prices obtained from third-party pricing vendors; the second was the use of prices obtained from one or more third-party broker-dealers; and the third and least preferred method was the use of prices recommended by the fund's portfolio management team. Despite having this three-tiered system, management relied on prices obtained from a single broker-dealer (second tier) or prices recommended by the portfolio management team (third tier) even though the fund was receiving vendor prices (first tier) because no diligence and oversight process was in place to monitor the use of such single broker-dealer quotes or prices recommended by the portfolio management team. Similar to the previously mentioned BDC enforcement action, the SEC alleged management withheld negative information around some of the securities' valuations from the valuation committee. The SEC staff noted that registrants, in certain cases, could rely on a single broker-dealer quote; however, controls and procedures should be in place to monitor how the broker-dealer is deriving the quote. Management should make every effort to obtain multiple quotes whenever possible and should work with their pricing vendors to price those securities for which only a single broker quote is available. The SEC staff reviews a registrant's price challenge process, sources used for pricing, and the board's involvement in the valuation process. The full text of the enforcement action is available at www.sec.gov/litigation/admin/2009/34-60059.pdf.

Interactive Data

.79 In February 2009, the SEC issued a final rule that will require funds to submit their risk and return summaries in interactive data, beginning with initial registration statements, and posteffective amendments that are annual updates to effective registration statements that become effective after January 1, 2011. The full text of the rule is available at www.sec.gov/rules/final/2009/33-9006.pdf. The commission has not determined whether the schedule of investments and financial statements will be required to be filed in interactive data.

SEC Comments and Observations

Disclaimer: The following comments represent the views of the accounting staff of the SEC's Division of Investment Management and do not necessarily reflect the views of the commission or other members on the commission's staff. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

General

.69 The SEC staff encourages consultation on unique or difficult accounting and reporting issues. To facilitate the consultation process, the SEC has a dedicated e-mail address (imoca@sec.gov) and a dedicated phone number (202-551-6918).

.70 Section 408 of SOX requires the SEC to review financial statements of all registrants at least once every three years. For investment companies, the review process is performed by a dedicated group in the Division of Investment Management, who review the financial statements of an entire complex. The staff will also take the opportunity to review related financial statements when a Form N-14 related to business combinations is filed. Often, for investment companies, staff comments are provided verbally to either an internal or external attorney representing the fund organization; the staff encourages accountants within fund organizations to participate in those conversations, as direct communication avoids misunderstandings about accounting-related comments.

Consolidation and Investees

.71 Rule 6-03(c) of Regulation S-X states that "[financial] statements of [an investment company] may be consolidated only with [financial] statements of subsidiaries which are investment companies." However, the SEC staff has not objected to consolidation of noninvestment company subsidiaries in certain cases (see letters to Fidelity Select Portfolio, April 29, 2008, and NGP Capital Resources Company, December 28, 2007). The staff has recently become aware of certain special purpose vehicles (SPVs) that typically would be consolidated under FASB ASC 810, Consolidation, but have not been consolidated based on Rule 6-03(c). The staff encourages registrants to consider the substance as well as the form of the relationship between the investment company and SPVs and whether consolidation more appropriately reflects overall financial position and results of operations.

.72 The staff has also observed an increase in the number of registrants making significant investments in nonregistered investment companies. The staff has requested, if the registered investment company's investment in the nonregistered investment company exceeds 25 percent of the fund's net assets, inclusion of the nonregistered company's financial statements as part of the registered investment company's shareholder report. Further, the nonregistered company's financial statements would be required to meet the form and content requirements of Regulation S-X, including a Schedule of Investments to the same level of detail as for the registered investment company itself (that is, both presenting either complete schedules of investments in the shareholder report under Rule 12-12 of Regulation S-X, or condensed schedules under Rule 12-12C of Regulation S-X in the shareholder report together with complete schedules in the registered company's Form N-CSR filing).

Fair Valuation

.73 The volume of changes and updates in FASB's fair valuation standards (FASB ASC 820, *Fair Value Measurements and Disclosures*) has resulted in differing levels of disclosure of valuation policies, including inputs and assumptions, among fund complexes. The SEC staff noted that FASB's intent is for the granularity of disclosure to increase as the valuations increasingly become based on less observable factors.

.74 The staff has received questions on the effective dates of the additional disclosures on transfers adopted as part of Accounting Standards Update (ASU) No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. The stated effectiveness is for fiscal years and interim periods beginning after December 15, 2009. The staff observed that this reporting convention is similar to that provided in FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, and should be understood in a similar manner, as requiring adoption for any interim period beginning after December 15, 2009, including the final interim period for the year. Thus, for example, a fund with a fiscal year-end of November 30, 2010, would adopt the standard for its Form N-Q filing for the quarter ended August 31, 2010, as well as its November 30, 2010, annual report, because the final six months of the year represent an interim period beginning after December 15, 2009.

.75 The recent FASB financial instruments exposure draft, which would require investment companies to report all liabilities, including term debt, at fair value, had raised questions about whether fair value or contractual amounts outstanding would be used to calculate asset coverage under Section 18 of the 1940 Act. The staff expressed its view that these tests should be calculated based on the contractual amounts outstanding.

Derivatives

.76 In relation to the July 30, 2010, letter issued to the ICI (http://sec.gov/divisions/investment/guidance/ici073010.pdf) on the disclosure of derivatives in prospectuses and shareholder reports, the staff made the following comments. The staff observed that both the letter and the following comments were not intended to impose requirements in addition to those in FASB ASC 815, *Derivatives and Hedging*, Regulation S-X, or Form N-1A, but rather to enhance transparency of disclosure to shareholders and provide enough information to assist investors in understanding the extent, risks of, and reasons for derivatives use.

- The staff reminded registrants that Form N-1A requires registrants to identify, among other things, how the fund intends to achieve its investment objectives by identifying the fund's principal investment strategies (including the type or types of securities in which the fund invests or will invest principally). The staff also reminded registrants that for non–money market funds, Form N-1A requires MDFP to discuss factors that materially affected the fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund's investment adviser.
- Prospectus disclosures should be written in "plain English" and provide meaningful disclosure of the reasons for and intended use of derivatives (for example, hedging, speculation, and substitute for conventional securities) and related risks, as required by Items 4 and 9 of Form N-1A. Prospectus disclosures

should also provide enough information so that shareholders can understand the extent to which derivatives are expected to be used. The staff indicated that registrants are not expected to disclose a percentage to convey extent; however, registrants should provide some disclosure of anticipated exposure. Disclosures contained in the prospectus should be tailored to include the derivative types that represent “principal investment strategies of the Fund,” with the full list of derivatives which may be used appearing in the statement of additional information. The staff reminded registrants that if a fund changes its investment strategy during the year to invest in derivatives, the fund can “sticker” its prospectus to meet its disclosure obligations of informing shareholders of principal investment strategies. Risk disclosures in the prospectus should provide shareholders with a complete risk profile of the fund’s investments taken as a whole and should be adequately tailored based on anticipated derivatives usage as opposed to being a list of risks of all types of derivatives strategies the fund “may” employ. In reviewing prospectuses as part of the derivatives study, the staff compared prospectus disclosures to historical usage as presented in the prior two to three years of financial statements to identify those strategies which appeared to be “principal” strategies as opposed to those which were infrequently employed. The staff observed that in certain cases, many funds in a fund family had the same derivative disclosures in their prospectuses despite significantly differing levels of derivative usage (for example, the same disclosures were made for funds in the fund family which used derivatives extensively and for other funds in the same fund family which did not use derivatives).

- The staff reminded registrants that when they update their registration statements, they should determine whether any prospectus disclosures need to be revised based on derivative usage in the financial statements and anticipated derivatives usage.
- The discussion of derivatives’ effect on the fund’s performance contained in MDFP should be tailored to the derivatives usage reported in the statement of operations, with adequate discussion of the effect on return (positive or negative), if material. The staff observed in its financial statement reviews that in certain cases MDFP did not discuss the impact of derivatives on performance even when the funds used derivatives as a principal investment strategy and

derivatives had a material impact on performance. The staff also observed instances in which derivatives had a material impact on performance but the MDFP contained forward looking disclosure regarding derivative use and did not discuss the impact of derivatives on performance (for example, MDFP indicated the fund may achieve exposures to issuers, interest rates, and currencies through investments in derivatives but did not discuss the impact of derivatives on performance).

- The staff continues to remind registrants that financial statement disclosure required by FASB ASC 815-10-50-1A of how and why funds use derivatives during the reporting period should be tailored to the actual reasons for derivative use, rather than reciting the reasons for why derivatives "may" be used or copying prospectus disclosure. The staff encourages financial statement preparers to discuss the reasons for derivatives use with portfolio managers to enhance the disclosure's relevance. Additionally, the staff observed that footnotes within a fund complex should be tailored to the actual extent of derivatives usage by individual funds, rather than using identical disclosure for all funds regardless of the level of activity.
- Disclosure of the volume of derivatives use, as required by FASB ASC 815-10-50-1A, should be presented in a manner which is meaningful to shareholders. The staff noted that there is flexibility in how to disclose the volume of use and encouraged registrants to leverage other information in the financial statements, where appropriate. It is acceptable, where appropriate, to state in narrative form that the period-end positions reported in the schedule of investments and the realized and unrealized gain or loss from derivatives appearing in the statement of operations are indicative of the volume of derivatives used during the period, to present ranges (minimum and maximum) of use during the year, or to present an average notional volume for the year.
- For disclosure of credit derivatives, the staff observed that in some instances it was difficult to identify whether a registrant had purchased or sold a particular position, with the only distinction apparent from inclusion of the additional disclosure of the current status of the payment or performance risk of the credit derivative required by FASB ASC 815-10-50-4K for written credit derivatives. The staff urged identification between purchased and written derivatives in a manner that is clear to less sophisticated readers. Similarly, when credit

derivatives are sold, and the additional FASB ASC 815-10-50-4K disclosure requirement of risk of performance under the contract is expressed by presenting current credit spreads, an explanation should be provided of the relationship between the size of the credit spreads and the likelihood the fund will have to make payment to the counterparty under the derivative contract to enhance transparency.

- The staff observed that certain funds did not disclose the counterparties to OTC swaps and forwards in the financial statements. The disclosure of counterparties to OTC derivative contracts is, in the staff's view, a material component of the security description as required by Regulation S-X. However, counterparties to exchange-traded derivatives need not be disclosed as, typically, the exchange stands behind the performance obligation under the contract regardless of the executing counterparty.

Changes of Period-Ends; Fund Mergers

.77 Generally, Rule 30e-1 of the 1940 Act, "Reports to Stockholders of Management Companies," requires investment companies to transmit financial statements to shareholders at least semiannually, within 60 days after period-end. The staff has delegated authority to grant extensions to the transmission requirement if the fund can demonstrate "good cause." If an investment company changes its fiscal year-end or semiannual reporting period by one month, the staff may provide no-action relief to allow a 15-day delay in order to issue a single shareholder report containing financial statements with separate columns and separate schedules of investments for the most recent six-month or annual period along with the short one-month "stub" period. For example, if in April an investment company changes its fiscal year-end from July 31 to August 31, the registrant can request relief to issue a single report, containing financial statements for the 12 months ended July 31 and the one-month period ended August 31, within 75 days of July 31. Another example is when an investment company changes its fiscal year-end from January 31 to August 31, in lieu of providing an unaudited semiannual report to shareholders for the six-month period ended July 31, the registrant can request relief to issue a single audited report, containing financial statements for the seven-month period ended August 31, within 75 days of July 31. In both examples, all periods presented must be audited, transmitted to shareholders, and filed on Form N-CSR within 75 days of July 31. A form letter is available from the staff to request the no-action relief containing the applicable conditions; registrants anticipating a one-month change in fund reporting periods are encouraged to contact the staff to obtain the form letter.

.78 The reporting of pro forma financial information in Form N-14 filings for investment company mergers is governed by Article 11 of Regulation S-X. Rule 11-02(b)(1) of Regulation S-X permits a narrative description of the pro forma effects of the transaction in lieu of condensed pro forma financial statements when there are a limited number of pro forma adjustments and those adjustments are easily understood. Narrative descriptions should include significant elements of the transaction, including, but not limited to

1. A general description of the merger, including the identification of the investment company whose financial performance will be carried over to financial statements prepared in future periods;

   Note: For transactions structured as mergers of multiple registered management investment companies, disclosure of whether the mergers are contingent upon the target companies' shareholders approving the merger.

2. Disclosure of the cost of the merger to each of the participating registered management investment companies and rationale for cost allocation, whether or not the merger is consummated;

3. A general description of the tax consequences of the merger, including the capital loss carryforwards available to each investment company and whether those capital loss carryforwards are subject to expiration or limitation;

4. Disclosure of information related to portfolio realignment, if any, that will take place after consummation of the merger, including

   a. the reasons for portfolio realignment,

   b. the extent and cost of portfolio realignment,

   c. the percentage of the target company's portfolio that is expected to be sold as a result of portfolio realignment and an estimate of the related realized gains expected to result from such sales, and *d.* a statement that total merger costs do not reflect commissions that would be incurred during portfolio realignment;

5. Pro forma effects of the transaction (assuming all investment companies subject to merger had merged) on
   a. the significant accounting policies, including valuation policies,
   b. net assets,
   c. management fees and other expenses, and
   d. any other significant adjustments resulting from the transaction; and
6. Reference to the audited financial statements of each investment company participating in the merger

Money Market Funds

.79 The staff has noted inconsistencies in the maturity dates of portfolio securities that are disclosed in money market funds' schedules of investments. The staff has taken the position that when disclosing maturity date required by Article 12-12 of Regulation S-X, at a minimum, money market funds should report the date when the fund is unconditionally permitted to demand repayment (the "demand date"). Reporting the demand date is consistent with the recently adopted weighted average life calculation under Rule 2a-7 of the 1940 Act. In addition to reporting the demand date, money market funds may also report the next interest rate reset date and the legal maturity date. Also, the staff believes this guidance to be appropriate for other types of fixed-income funds (for example, ultra-short bond funds).

.80 The staff has received inquiries from registrants who manage multiclass money market mutual funds. In certain instances, a fund may have realized a loss on a portfolio security which was appropriately allocated among the fund's classes on the realization date. Subsequently, one of the classes had a significant redemption that caused the net asset value per share of that individual class to deviate from a constant $1.00, even though it is immediately evident that the fund as a whole is not impaired (that is, the fund as a whole did not "break the buck"). The staff expressed a view that, in these instances, it is not inconsistent with Rule 18f-3 under the 1940 Act to reallocate the loss among classes based on the relative net assets attributable to each class at the current date as long as the following conditions are met: (i) All shareholders subscribe to and redeem from the money market fund at $1 per share; (ii) One class "breaks the buck" due to a large redemption which was processed at $1 per share but the fund's shadow priced net asset value (NAV) measured at the fund level does not "break the buck;" (iii) the fund's Board of Directors believes that retroactive reallocation is in the best interests of shareholders, is fair to shareholders, and approves the reallocation in accordance with Rule 18f-3; and (iv) the retroactive reallocation results in an annualized rate of return of each class that differs by class specific expenses.

.81 Finally, the staff reminded registrants that Item 74W of Form N-SAR requires registrants to report the NAV of money market funds based on a "mark-to-market" value (that is, the "shadow price") of the fund at the period-end date, not at the amortized cost value.

SEC Staff Comments and Observations

Disclaimer: The following comments and observations were compiled by the AICPA Investment Companies Expert Panel and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff. This is not intended to be a comprehensive list.

Custody Rule

Enforcement Action

.57 In October 2010, there was an enforcement action against a public accounting firm related to the surprise examination requirement of Rule 206(4)-2 of the Advisers Act (the custody rule). The principal issue was that the adviser commingled client securities with the adviser's proprietary securities, as the adviser moved client securities from client accounts to the adviser's proprietary collateral account. These client securities were pledged as collateral for the adviser's proprietary loan. Such commingling is prohibited by paragraph (a)(1) of the custody rule which requires, among other things, client assets of which the adviser has custody to be maintained by a qualified custodian (i) in a separate account for each client under that client's name or (ii) in accounts that contain only [the adviser's] clients' funds and securities, under [the adviser's] name as agent or trustee for the clients. However, the audit firm's opinion indicated that the adviser complied with the aforementioned requirement and did not qualify the surprise examination report. More information on the case can be accessed at www.sec.gov/litigation/admin/2010/34-63030.pdf.

Pooled Investment Vehicles—Audit Provision

.58 Question VI.5 of the SEC staff's custody rule FAQs discusses when using the "audit approach" (also referred to as the "audit provision") for PIVs under Rule 206(4)-2(b)(4) of the Advisers Act that the financial statements must be prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) and audited by an accounting firm that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB) utilizing U.S. generally accepted auditing standards. The financial statements must be distributed to investors within 120 days of the fiscal year end (or 180 days for funds of funds, see question VI.7 of the SEC staff's custody rule FAQs; or 260 days for a "top tier" PIV that invests in one or more funds of funds, see question VI.8B of the SEC staff's custody rule FAQs). PIVs organized outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, may have their financial statements prepared in accordance with standards other than U.S. GAAP so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP and contain a reconciliation of any material differences with U.S. GAAP. The SEC staff's custody rule FAQs indicate that the Division of Investment Management would not recommend enforcement action if such reconciliation is included only in the financial statements delivered to U.S. persons.

Pooled Investment Vehicles—Multiple Audit Opinions

.59 There may be situations in which a PIV may need two audit opinions due to the requirements of the custody rule. For example, a firm needs to be registered with, and subject to regular inspection by the PCAOB, but they also may have a separate requirement by certain local regulators for a firm which is locally registered but may not be subject to regular PCAOB inspection. The SEC staff indicated that it would not object to including two audit opinions with one set of financial statements or to advisers distributing a letter to their investors explaining why there are two audit opinions. Additionally, in Schedule D, Section 7.B.(1), of Form ADV, SEC-registered investment advisers (RIA) must identify, among other things, the name and address of the independent public accountant who audited a private fund and whether the independent public accountant issued an unqualified opinion. For entities that have audit opinions issued on their financial statements out of the United States for purposes of the custody rule, and out of another jurisdiction due to local regulatory requirements, the SEC staff indicated that both the U.S. and local accounting firms should be listed on Form ADV.

Pooled Investment Vehicles—Accounting Standards Application

.60 There may be a situation in which international financial reporting standards (IFRSs) are being used for certain funds in a master feeder structure (with a U.S. adviser, U.S. feeder fund, offshore feeder fund, and offshore master fund). If the U.S. feeder fund is presented in accordance with U.S. GAAP and the offshore feeder is presented in accordance with IFRSs, for purposes of complying with the custody rule as indicated by the SEC staff, the basis of accounting for the master fund would generally be U.S. GAAP. However, if the master fund was prepared on another basis of accounting that was substantially similar to U.S. GAAP and any material differences were reconciled to U.S. GAAP, this other basis may be permitted.

.61 As required by Rule 206(4)-2(b)(4) of the Advisers Act, advisers to PIVs complying with the custody rule by distributing audited financial statements prepared in accordance with U.S. GAAP to investors (that is, "Audit Provision") must also distribute audited financial statements prepared in accordance with U.S. GAAP upon liquidation of the pool to all limited partners (or members or other beneficial owners), even when the liquidation occurs prior to the fund's fiscal year-end.

Pooled Investment Vehicles—Form ADV-E

.62 Pursuant to Rule 206(4)-2(a)(4)(iii), the required written agreement between the investment adviser and the independent public accountant for the surprise examination must provide that, upon the independent public accountant's resignation, dismissal, or other termination, the independent public accountant must file within four business days a statement regarding the termination along with Form ADV-E. If an adviser uses the surprise examination with respect to a PIV in one year and in the following year determines it will be able to rely on the audit provision with respect to that PIV and engages the same independent public accountant to perform that audit, the adviser should initiate a filing of Form ADV-E since the independent public accountant will not be reappointed for the surprise examination in the following year. Form ADV-E would need to be filed in the Investment Adviser Registration Depository (IARD) system within four business days of determining that the adviser would be relying on the audit provision.

Pooled Investment Vehicles—Special Purpose Vehicles Considerations

.63 As discussed in Release No. IA-2968, advisers to PIVs may use special purpose vehicles (SPVs) and control these SPVs themselves or through a related party. To comply with the custody rule in this situation, the adviser could either treat the SPV as a separate client (in which case the adviser will have custody of the SPV's assets) or treat the SPV's assets as assets of the PIVs of which it has custody indirectly. If the adviser treats the SPV as a separate client, the adviser must comply separately with the custody rule's audited financial statement distribution or account statement and surprise examination requirements. These financial statements or account statements would be distributed to the beneficial owners of the PIVs. Alternatively, if the adviser treats the SPV's assets as assets of the PIVs of which it has custody indirectly, such assets must be considered within the scope of the PIV's financial statement audit or surprise examination.

.64 There may be a situation when multiple funds invest in a SPV and the SPV liquidates before the funds' fiscal year-ends. The SEC staff indicated that the funds can use the SPV provision discussed previously in this section and include the SPV's assets or final distributions within the scope of the fund audits in lieu of performing a liquidation audit of the SPV. Due to the related party nature of this relationship, and even if these distributions are immaterial to each fund, the independent public accountant may consider performing additional testing on the SPV.

Pooled Investment Vehicles—Commodity Pool Considerations

.65 If an SEC-registered adviser manages a commodity pool that holds treasuries (as securities) in its margin account, the SEC staff indicated that the commodity pool would be an advisory client due to its holdings of the treasury securities. Therefore, the adviser would be subject to the custody rule with respect to the portion of assets in such commodity pool that are funds and securities. However, the SEC staff noted that if the commodity pool was audited and the audit met the audit provision requirements of the custody rule, the adviser would satisfy the custody rule with respect to the commodity pool. In the year of liquidation, if the pool is liquidated at a time other than the end of a fiscal year, even if the CFTC does not require a liquidation audit, the custody rule would require one if the adviser is relying on the audit provision.

Pooled Investment Vehicles—Audit Considerations

.66 Situations may arise in which a PIV commenced operations in December 2010, did not have an audit performed in 2010 because the adviser was not registered with the SEC, and the adviser managing the PIV registered with the SEC for the first time in July 2011. At the end of 2011, the PIV has a 13-month audit performed. The SEC staff indicated this 13-month audit (as opposed to the annual 12-month audit), would satisfy the annual audit provision exception under the custody rule as long as the balance sheet is presented for every year that the adviser is subject to the custody rule. In this case, a balance sheet as of December 31, 2011, and a 13-month income statement and statement of changes would be sufficient. Presenting two sets of financial statements (one for the year and another for the stub period) may also be acceptable. Additionally, if the fund liquidates on February 29, 2012, the balance sheets for both December 31, 2011, and February 29, 2012, an income statement and statement of changes in equity for the 12-months ended December 31, 2011, and for the two months ended February 29, 2012, would be required (assuming the PIV is exempt from the requirement to provide a statement of cash flows). This is because, in this scenario, the adviser is subject to the custody rule for both 2011 and 2012. However, if the adviser was registered in 2010, the audit for the period ended December 31, 2010, would also be required.

Pooled Investment Vehicles—Privately Offered Securities

.67 In accordance with Rule 206(4)-2(b)(2) of the Advisers Act, for advisers of PIVs, the exception from holding privately offered securities with a qualified custodian for PIVs is only available if the PIV meets the criteria for the audit provision. Therefore, privately offered securities held by a PIV that is not using the audit provision are required to be held with a qualified custodian. For a fund of funds that does not utilize the audit provision, this may result in the qualified custodian holding the original partnership and subscription agreements for investments in underlying funds. See also question VII.2 of the SEC staff's custody rule FAQs for additional information.

Pooled Investment Vehicles—Defined Contribution Plans

.68 As discussed in question XII.1 of the SEC staff's custody rule FAQs, a related person of an investment adviser may act as the trustee of a participant-directed defined contribution plan established for the benefit of the adviser's employees. Further, as the trustee, this related person may select the service providers for the plan, and may select the investment options available under the plan (for example, mutual funds). The assets of the plan do not need to be treated as client assets of which the adviser has custody in these circumstances solely because the related person of the adviser is trustee, provided that

- neither the investment adviser nor a related person otherwise acts as an investment adviser to the plan or any investment option available under the plan, and
- the investment adviser and the related person trustee are, to the extent applicable, in compliance with the Employee Retirement Income Security Act of 1974 and rules and regulations issued there under with respect to the plan.

.69 However, the adviser is deemed to have custody of the plan when one of the plan's investment options is a PIV managed by the adviser. The SEC staff indicated that, in this situation, all of the plan assets are subject to the custody rule as both the plan and the fund are clients of the investment adviser.

Club Deals

.70 Club deals are when multiple, unrelated investment advisers jointly make an investment in a private company on behalf of funds they manage, and such arrangements are common in private equity funds. The private investment is owned by a holding company and one of the participating investment advisers may act in a control capacity. The holding company is generally not audited as a stand-alone entity. The SEC staff indicated that if the holding company was considered an advisory client, the adviser could comply with the custody rule by using the audit provision and delivering the holding company's audited financial statements to investors in the private equity fund(s). Investment advisers should consider consulting with their legal counsel on this matter.

Surprise Examination—Attestation on the Entity's Compliance

.71 The SEC staff noted that when an independent public accountant performs a surprise examination under Rule 206(4)-2 of the Advisers Act or an examination pursuant to either Rule 17f-1 or 17f-2 of the 1940 Act and attests directly on the entity's compliance, and not on management's assertion about compliance, that management's assertion would not need to be filed with the SEC.

Surprise Examination—Closed Client Accounts

.72 As discussed in Release No. IA-2969, the independent public accountant should include accounts that were closed during the period or that have a zero balance as of the date of examination in the scope of the surprise examination. If a client account was closed due to the death of the client, the independent public accountant may consider examining the death benefit disbursement and death certificate to validate it is in accordance with the annuity contract, or other alternative procedures.

Surprise Examination—Previous Noncompliance

.73 There may be situations when the independent public accountant is first engaged to perform a surprise examination in 2011 and during the course of that examination, realizes that the adviser should have had a surprise examination performed in 2010 but did not engage an independent public accountant to perform a surprise examination in 2010. Rule 206(4)-2(a) of the Advisers Act generally requires that client funds and securities of which an investment adviser has custody be verified by actual examination at least once during each calendar year by an independent public accountant. An investment adviser required to obtain a surprise examination must have entered into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010. The SEC staff stated this fact pattern could be indicative of a material discrepancy with the provisions of Rule 206(4)-2 of the Advisers Act. If it were deemed to be a material discrepancy, the independent public accountant must report to the SEC within one business day of the finding. Based on the facts and circumstances, the independent public accountant may consider performing additional testing for the prior year even though they were not engaged for that period.

Surprise Examination—Date Selection

.74 Based on question I.3 of the SEC staff's custody rule FAQs, an investment adviser may have engaged an independent public accountant to perform the first surprise examination as of early 2011 (for example, January 31, 2011). If the next surprise examination will be performed in the next calendar year as of November 30, 2012, there would be a 22-month time period between surprise examinations. The SEC staff indicated that as long as the November 30, 2012, examination is conducted on a "surprise" basis, the date would be acceptable as Rule 206(4)-2(a)(4) of the Advisers Act requires the surprise examination to be performed at least once per calendar year. Per Release No. IA-2969, the independent public accountant is also required to opine on the adviser's compliance with

Rule 204-2(b) of the Advisers Act for the period since the prior surprise examination, which in this example, would cover the 22-month period.

.75 Question IV.6.B of the SEC staff's custody rule FAQs explains that filing Form ADV-E and the surprise examination report is a two-step process for the independent public accountant. First, the adviser must submit a Form ADV-E in IARD that identifies the independent public accountant who will be performing the surprise examination. Next, the independent public accountant receives an email from IARD providing a unique, secure link which allows the independent public accountant to upload a surprise examination report to IARD. In a situation when a registrant or an independent public accountant determines that an incorrect Form ADV-E was filed by the independent public accountant or if an independent public accountant wants to revise the form filed, the independent public accountant must file a new Form ADV-E and provide an explanation about why the original form is being amended. This is because revisions cannot be made to previously submitted documents.

.76 Independent public accountants filing Form ADV-E have encountered difficulties uploading a single, text-searchable document that contained both the independent public accountant's examination report and management's assertion statement, as is required by the IARD filing system. The SEC staff has indicated one submission is preferred (as opposed to multiple documents being uploaded) and only one document may be uploaded per each Form ADV-E within the IARD filing system as well. One way for users to accomplish this, that the SEC staff has indicated is acceptable, is for the independent public accountant to produce its surprise examination report and obtain management's assertion statement in Microsoft Word format and merge the two documents into one document; then, type in the signature for the surprise examination report and management's assertion (//Accounting Firm X LLP//, and //Adviser XX Name//), respectively, as applicable. The Word document can then be converted into a PDF document and uploaded to IARD. Independent public accountants should retain a physically signed copy of management's assertion statement for their records. Another way to accomplish this is to prepare the signed independent public accountant's report in a text-searchable PDF document and include the signed management assertion statements within the document as a picture image.

Trial Compliance Surprise Examinations

.77 Some investment advisers engage compliance professionals to perform diagnostic mock (trial) examinations to identify potential compliance issues prior to SEC registration. If the adviser is not registered with the SEC at the time of the mock examination, there would be no material discrepancy with the custody rule to report (if found), as the adviser is not obliged to comply with the custody rule until registration. However, the independent public accountant's obligations under professional standards and federal securities laws and regulations need to be considered.

.78 Additionally, when the actual surprise examination occurs and management signs the letter of representations, typically a representation is included that management has disclosed to the accounting firm all known noncompliance and any communications from regulatory agencies, internal auditors, and other practitioners regarding possible noncompliance with the specified requirements. This would likely include the material discrepancy discovered during the mock examination that the practitioner reported to management.

Dual Registrants

.79 As explained in the definition of custody in Release No. IA-2968, custody includes possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless they are received inadvertently and they are returned to the sender promptly, within three business days of receiving them.

.80 Questions about how to comply with the custody rule arise for dual registrants—registered investment advisers that are also registered broker-dealers—as certain introducing broker-dealers may be required under Rule 15c3-3 of the Securities Exchange Act of 1934 to send third-party issued checks on behalf of clients promptly to the clearing broker. If an adviser is dually registered as an introducing broker, the introducing broker may receive client checks and act as a qualified custodian. For example, checks are made out to the introducing broker and the introducing broker cashes the checks and sends the proceeds promptly to the clearing broker. If this is the case, as a qualified custodian in accordance with Rule 206(4)-2(a)(6) of the Advisers Act, the introducing broker would be required to obtain an internal control report even if the introducing broker sends the checks promptly to the clearing broker in accordance with the SEC's rules. Pursuant to question XIV.2 of the SEC staff's custody rule FAQs, if a check is made to a third party and given to the introducing broker who is dually registered as a registered investment adviser, no internal control report is required.

SEC Filings Observations

Incentive Fee Accrual

.81 Technical Questions and Answers (TIS) section 6910.29, "Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations" (AICPA, *Technical Practice Aids),* discusses how cumulative period-end unrealized gains and losses, carried interest, and clawback obligations should be reflected in the equity balances of each class of shareholder or partner interest at the balance sheet date of a nonregistered investment partnership. If a nonregistered investment partnership reports capital by investor class, cumulative unrealized gains and losses, carried interest, and clawback provisions would be reflected in the equity balances of each class at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, allocated all gains and losses, and distributed the net assets to each class at the reporting date consistent with the provisions of the partnership's governing documents.

.82 Certain BDCs are accruing incentive fees in their financial statements based on the amount by which net realized gains (that is, realized gains less realized losses) exceed unrealized losses and are excluding unrealized gains in this calculation. This incentive fee accrual methodology is not in accordance with the accrual basis of accounting in generally accepted accounting principles (GAAP) or TIS section 6910.29. BDCs should accrue incentive fees based on the amount by which net realized gains and unrealized gains exceed unrealized losses even though Section 205(b)(3) of the Advisers Act prohibits advisers from receiving payment of fees based on unrealized gains.

.83 Certain BDCs structure their advisers' incentive fees based on achieving a specific cumulative total return hurdle; that is, the adviser may not be entitled to the incentive fees if the cumulative total return hurdle does not exceed a certain percentage (hurdle rate). If there is a total return hurdle, BDCs should accrue incentive fees for financial reporting purposes as if all the assets and liabilities have been liquidated at fair value at the reporting date, consistent with TIS section 6910.29. Therefore, if a BDC's cumulative performance (including performance attributable to unrealized gains) exceeded the hurdle rate, an incentive fee would be accrued. Conversely, if a BDC's cumulative performance (including performance attributable to unrealized gains) did not exceed the hurdle rate, an incentive fee would not be accrued. For example, if 8 percent is the hurdle rate and the BDC achieved a 10 percent return, the incentive fee should be accrued even on the unrealized gains. This accrual would differ from the amount currently payable to the adviser under Section 205(b)(3) of the Advisers Act if the accrual is based on unrealized gains. If a 7 percent return was achieved with the same hurdle rate, the incentive fee would not need to be accrued.

.84 If a registrant's cumulative total return on a hypothetical liquidation basis is less than the total return hurdle rate and no incentive fee is accrued as of the balance sheet date, registrants should provide the following disclosures:

- Amount of cumulative net investment income, cumulative net realized, and cumulative net unrealized gains that would be subject to the incentive fee accrual if the BDC had achieved the hurdle rate at the balance sheet date
- Amount of the incentive fee that would be accrued as of the balance sheet date if the BDC had achieved the hurdle rate, or if not practical based on the calculation methodology (for example, due to catch up clauses and so on), the maximum incentive fee that could be accrued (for example, 20 percent of cumulative net income less prior incentive fee accruals)
- Amount of cumulative total return (or metric used for the hurdle rate) as of the balance sheet date in order to inform the shareholder how close the BDC is to achieving the hurdle rate (for example, 8 percent hurdle and current return is 7.7 percent)

Financial Statements of Significant Subsidiary

.85 Rule 3-09 of Regulation S-X describes requirements for when separate financial statements of a significant subsidiary should be filed with the SEC and when those separate financial statements must be audited. It also explains that, insofar as practicable, the separate financial statements required should be as of the same dates and for the same periods as the audited consolidated financial statements required by Rules 3-01 and 3-02 of Regulation S-X. The SEC staff noted an instance where the registrant did not meet the requirements of Rule 3-09 since the registrant included financial statements of the significant subsidiary which were unaudited. Registrants may consult with the SEC staff to discuss financial statement requirements of significant subsidiaries.

Business Development Companies Observations

.86 The following are some SEC staff observations related to business development companies:

- Diversity in practice exists around BDCs consolidating SPVs that are not considered investment companies under the 1940 Act. While Rule 6-03(c) of Regulation S-X expresses the general policy that a registered investment company should not consolidate any entity that is not itself an investment company, the SEC staff noted that advisers should evaluate to determine whether consolidation would be more appropriate based on current U. S. GAAP (FASB ASC 810, *Consolidation*), or if there should be additional disclosure to provide transparency in the footnotes of the relationship between the BDC and the SPV. The SEC staff also noted that Rule 3A-02 of Regulation S-X presumes that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity either directly or indirectly has a controlling financial interest in another entity. The SEC staff also indicated that in certain circumstances, there may be a requirement to audit the SPV and attach the related financial statements.
- The SEC staff also noted a registration statement whereby the registered investment adviser paid offering costs, but the BDC would reimburse the adviser for these costs if certain circumstances were met or upon liquidation. There was no indication of these costs being reflected in the BDC's seed balance sheet or the note disclosures. Under the terms of the reimbursement agreement, it appeared the BDC would be virtually unable to escape repayment (regardless of it being successful or unsuccessful), as it would inevitably ultimately liquidate. Therefore, the SEC staff's view was that the BDC would need to record those costs currently. This position was analogized to their position taken on expense recapture plans which enable the adviser to recoup previously waived fees if the fund operates below its expense cap in future years. If an adviser is waiving fees, but recoupment is probable, the fund would need to accrue the recoupment which would offset the benefit of a current year's waiver.

- The SEC staff had four additional observations from recent reviews of BDC financial statements:

  — Certain BDCs did not disclose maturity dates of portfolio loans on their schedule of investments (SOI), as required by Rule 12-12 of Regulation S-X.

  — For securities that pay a combination of cash and payment in kind (PIK) interest, some BDCs have reported the interest rate on these securities as the combination of the two rates and did not disclose that a portion of the interest is PIK. The SEC staff noted that registrants should disclose the portion of interest that is PIK and may also consider disclosing both the cash and PIK rates in the SOI or a footnote thereto.

  — A BDC had borne certain organization costs which were included in accumulated net investment loss on the seed balance sheet and disclosed in the notes to the financial statements. However, the BDC did not include a statement of operations reflecting the organization costs as an expense. The SEC staff asked for the statement of operations to be provided.

  — The SEC staff observed that certain BDCs have included U.S. treasury securities within the "Cash and Cash Equivalents" caption on the balance sheet. The SEC staff noted these securities should be categorized as investments and as such, reflected on the SOI.

- Some BDCs invest in total return swaps (TRS) as a form of financing through a consolidated wholly owned subsidiary. Typically, the BDC selects a portfolio of loans that are placed into the total return swap as the reference asset and is required to post collateral equal to 20–25 percent of the notional value of these loans with the counterparty. The BDC receives the cash interest and any realized gains on the portfolio of loans and pays a floating rate of interest plus any realized losses on that portfolio of loans to the counterparty. The SEC staff noted the cash posted as collateral in these transactions should be presented separately on the balance sheet (that is, not included in the "Cash" line item but rather a separate line item such as "Due From Broker"). The SEC staff observed that generally, the financial statements include a separate footnote which discloses the total return swap's key risks, contractual terms, and other disclosures required by FASB ASC 815, *Derivatives and Hedging*. For each loan comprising the reference asset, the SEC staff requested disclosure of the name of the loan borrower, the notional amount, the fair value, the interest rate, and maturity date. The SEC staff also requested disclosure of any termination or commitment fees that may be payable by the BDC to the counterparty and of how the total return swap would affect the calculation of the management fee and incentive fee payable to the adviser.

Surprise Examination Material Discrepancies

.87 Since the amendments to the custody rule have become effective, the SEC has received numerous notification letters from accounting firms regarding material discrepancies as a result of surprise examinations performed. These notifications included the following:

- Certain registered investment advisers did not comply with the quarterly account statement requirements of Rule 206(4)-2(a)(3) of the Advisers Act. One instance was when a qualified custodian held securities on an omnibus basis for an unrelated law firm and sent the quarterly account statements to the law firm, who then sent individual account statements to investors. The qualified custodian should have sent the account statements directly to the investors.
- A registered investment adviser received checks on behalf of clients and forwarded them to the qualified custodian instead of returning those checks to the sender within three business days of receiving them (as discussed in the definition of *custody in Rule 206(4)-2(d)(2))*.
- A registered investment adviser sponsored a PIV for which audited financial statements were not prepared in accordance with U.S. GAAP. Since the audit provision of Rule 206(4)-2(b)(4) of the Advisers Act could not be relied upon, a qualified custodian was required to send quarterly account statements to pool investors and hold all of the PIV's privately offered securities. The independent public accountant reported that quarterly account statements were not sent to investors by the qualified custodian and the PIV's privately offered securities were not held by a qualified custodian.
- An adviser used the privately offered securities exemption, but the securities did not meet the definition of privately offered securities. Rule 206(4)-2(b)(2) of the

Advisers Act generally exempts privately offered securities from the qualified custodian requirements established under Rule 206(4)-2(a)(1) of the Advisers Act provided certain requirements are met. Rule 206(4)-2(b)(2) defines "privately offered securities" as securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (ii) uncertificated and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

- Client funds and securities were held by an entity that is not a qualified custodian, as is required by Rule 206(4)-2(a)(1) of the Advisers Act.

Surprise Examination Reporting

.88 The SEC staff noted the following comments compiled during its review of certain surprise examination reports:

- The independent public accountant's surprise examination report should include an opinion on compliance with paragraph (a)(1) of Rule 206(4)-2 of the Advisers Act as of the examination date and with Rule 204-2(b) of the Advisers Act during the period since the prior examination date (or for a first year examination, compliance with Rule 204-2(b) since the date the adviser became subject to the rule. See question IV.5 of the SEC staff's custody rule FAQs). Some examination reports only covered compliance with paragraph (a)(1) of Rule 206(4)-2 of the Advisers Act, but they failed to mention compliance with Rule 204-2(b) of the Advisers Act regarding the registered investment adviser's maintenance of books and records which are required to be maintained. Other reports stated that the registered investment adviser was in compliance with Rule 204-2(b) only as of the examination date.
- Release No. IA-2969 states that the surprise examination is to be conducted in accordance with AICPA attestation standards and references AT section 601. An independent public accountant issued an agreed-upon procedures report, instead of a compliance examination conducted in accordance with AT section 601.
- Paragraph .24 of AT section 601 lists numerous elements that are required to be included in the practitioner's report. Certain surprise examination reports were

missing key reporting components, such as a statement that the subject matter is the responsibility of the entity's management, among other components.

- Certain independent public accountants reported on management's statement regarding compliance with certain provisions of Rule 206(4)-2 of the Advisers Act, but they did not include management's assertion in the filing.
- Certain surprise examination reports were missing key procedures, such as confirmation of funds or securities with clients (or other appropriate alternative procedures). *See* Release No. IA-2969 for further details of confirmation expectations.

Additional Investment Adviser Observations

.89 Additional areas of focus or findings from the Office of Compliance Inspections and Examinations (OCIE) inspections of investment advisers include

- Valuation of investments, including the documented policies and procedures for valuing client assets and calculating net asset value (NAV).
- Conflicts of interest, particularly related to fees expensed and compensation paid to the advisers.
- Custody, noting that during inspections OCIE is continuing to use some level of confirmation of client assets, and for private funds, OCIE may discuss confirmation procedures performed by independent public accountants during their audits of private funds. OCIE also may request access to review the independent public accountant's work papers to reduce the amount of confirmation requests it sends.
- An adviser of a PIV that was planning on using the audit provision did not have audited financial statements distributed within 120 days after year-end (or, in the case of a fund of funds, 180 days). This is required under Rule 206(4)-2(b)(4)(i) of the Advisers Act. Question VI.9 of the SEC staff's custody rule FAQs states that the SEC's Division of Investment Management would not recommend enforcement action against an adviser that is relying on the audit provision and could not deliver the financial statements on time if the adviser reasonably believed they would be distributed within the deadline, but it failed to have them distributed due to certain unforeseeable circumstances. This did not apply

in this scenario as the audited financial statements had been significantly delayed for multiple years.

Expense Recapture Plans

.90 Due to improved market conditions, funds that have expense recapture plans may need to pay back expenses that had previously been waived. The SEC staff has indicated that within a fund's registration statement, the funds should use a separate line item in the fee table, similar to the presentation treatment for a contractual fee waiver, for disclosure of the recaptured expense amount.

.91 Instruction 3(c)(iii) to Item 3 of Form N-1A (page 13) indicates that within the "Other Expenses" category, the fund may subdivide this caption into no more than three sub-captions that identify the largest expense or expenses comprising "Other Expenses." Frequently, the recaptured amount paid is not quantitatively significant and is not among the three largest components of "Other Expenses." However, due to the qualitative importance of this item, the SEC staff indicated that in such cases, the fund should separately present these amounts paid. The staff was not prescriptive in where the disclosure should be in the table and would not object if these amounts were presented similar to the presentation of a contractual fee waiver or if they are included in "Other Expenses," listed out separately, even when they are quantitatively not among the three largest components of "Other Expenses."

Form N-MFP Observations

.92 Rule 30b1-7 of the 1940 Act requires every registered open-end management investment company, or series thereof, that is regulated as a money market fund under Rule 2a-7 of the 1940 Act to file with the SEC a monthly report of portfolio holdings on Form N-MFP, as of the last business day of the previous month. This must be filed no later than the fifth business day of each month. The SEC will make the information filed on this form available to the public 60 days after the end of the month to which the information pertains.

.93 The SEC staff noted the following comments related to recently submitted Form N-MFP:

- Item 14 requires the total value of other assets; any cash held by the fund should be included in this item and not in Item 13, because cash does not qualify as a security.
- Item 27 requires the title of a security to include its description, coupon, or yield.
- Item 44 requires illiquid securities to be identified, which would include term repurchase agreements that extend beyond five business days.
- Items 17 and 24 require that the yield information should be input as a decimal point as opposed to a whole number percentage (that is, if the yield is 13 percent, ".13" should be entered rather than "13").
- Item 31 requires registrants to indicate categories of investments. Certain registrants were not categorizing securities correctly. For example, foreign sovereign debt should not be categorized as "Treasury Debt." Securities should be categorized based on the category that most closely identifies the instrument.

Consolidation

.94 The SEC staff noted the following scenario in which a registrant and its auditor consulted the staff: an open-end registered investment company (Fund) invests in a wholly owned, non–SEC-registered Cayman Islands tax blocker (Cayman Blocker). The Cayman Blocker invests in a wholly owned non–SEC-registered commodity pool (CP). The Fund's ultimate exposure to the CP could represent up to 25 percent of the Fund's total assets. The arrangement represents a three-tiered structure. The staff noted that the Fund consolidated the Cayman Blocker in its semiannual financial statements, but the Cayman Blocker did not consolidate the CP (and, therefore, the Fund did not consolidate the CP) even though the Cayman Blocker owns 100 percent of the CP and economically controls it. The Fund's semiannual financial statements reflected the investment in the CP within the investments line item on the balance sheet and reflected the name of the CP on the SOI. The Fund's semiannual financial statements did not provide any transparency into the holdings or expenses of the wholly owned CP. In addition, the Fund's expense ratio did not reflect the expenses of the CP. The registrant initially concluded the Fund, which consolidates the Cayman Blocker, should not consolidate the CP based on Rule 6-03(c)(1) of Regulation S-X that states that registered investment companies may only consolidate investment companies. The CP is neither an investment company, as defined in the 1940 Act, nor an entity that would be an investment company under the 1940 Act but for the exceptions in Sections 3(c)(1) or 3(c)(7).

.95 The staff informed the registrant that under GAAP, the consolidation analysis needs to be evaluated using a "bottom up" approach. First the registrant should determine whether the Cayman Blocker should consolidate the CP. Since both the Cayman Blocker and the CP are non–SEC-registered funds and are both investment companies under GAAP, the registrant determined the Cayman Blocker should consolidate the CP because it has a controlling financial interest in the CP. Next, the registrant should determine whether the Fund should consolidate the Cayman Blocker. Because the registrant had previously determined the Fund should consolidate the Cayman Blocker, the registrant determined it was appropriate to consolidate the whole three-tiered structure. Therefore, upon consolidation in its audited annual report, the Fund included all of the CP's investments in its SOI and included the CP's expenses in its statement of operations and expense ratio.

.96 Another registrant created a structure similar to the one described in the previous example in order to obtain exposure to commodities. In this fact pattern, an open-end registered fund invests in a wholly owned non–SEC-registered Cayman tax blocker and the Cayman tax blocker invests in five wholly owned non–SEC-registered commodity pools. The Fund's exposure to the commodity pools in the aggregate could represent up to 25 percent of the Fund's total assets. Subsequent to the SEC staff's review of the registrant's financial statements, this registrant concluded it was appropriate for all entities to be consolidated. The analysis performed by the registrant was similar to the one mentioned in the previous example.

.97 The SEC staff also noted that Rule 3A-02 of Regulation S-X presumes that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity either directly or indirectly has a controlling financial interest in another entity.

Variable Rate Demand Notes

.98 During the financial statement review process, the SEC staff observed that certain funds were holding variable rate demand (VRD) notes with liquidity enhancements (in addition to credit enhancements). The staff learned that only a few, large banks provide these liquidity enhancements and that not all mutual funds were disclosing the liquidity enhancements, the liquidity enhancement providers, and the possible credit concentration provided in these arrangements. The SEC staff reiterated that when funds have investments in securities with liquidity enhancements, funds should consider the guidance in FASB ASC 946-210 regarding identification of third parties providing credit enhancements. Similar disclosure should be considered and would include the name of the liquidity provider in the security's description in the SOI and discussion of the liquidity enhancement arrangements within the notes to the financial statements.

XBRL Filings

.99 Since provisions for filing certain prospectus data became effective on January 1, 2011, the SEC staff has received numerous questions which fall under three themes: filing process, the viewer, and website postings.

.100 Regarding the filing process, questions have been related to which form to use and how the filing should be made. The SEC staff noted that to help address some of these questions, registrants have the opportunity to perform a test filing before each actual filing within EDGAR. This test filing will allow the adviser to put the XBRL submission though EDGAR's validation process, and it can preview the submission to ensure data integrity and completeness.

.101 The SEC staff noted that the viewer should be used as a tool and should not be considered the end goal for XBRL filings. In using the viewer, the adviser should ensure that all data contained in the HTML version of the Risk/Return Summary is in the XBRL filing. Further, there are certain limitations to the viewer, most of which relate to formatting. Therefore, in certain circumstances, the XBRL data viewed in the viewer will not exactly match how it has been disclosed in its HTML version.

.102 There is also a requirement in the rule for website posting of the XBRL data. If a fund does not have a website, the SEC staff expects that it would be posted on a website from which an investor obtains that fund's financial information or literature. Typically, this would be the website of the fund's sponsor, distribution agent, or another appropriate third party.

.103 The SEC staff encourages users to submit any XBRL-related questions via email to Ask-oid@sec.gov.

Registered Funds of Hedge Funds

.104 The SEC staff noted that it has observed that certain registered funds of hedge funds with fiscal year-ends other than December 31 (for example, March 31) were not properly accruing incentive fees or allocations in their financial statements. Such registered funds of hedge funds usually have provisions in their offering documents that provide that incentive fees or allocations crystallize and are payable to the adviser/General Partner at December 31. The SEC staff has observed that certain of these registered funds of hedge funds accrue the incentive fees or allocations on the statement of operations or statement of changes through December 31 and disclose the amount of incentive fees or allocations payable from January 1 through March 31 in the footnotes. The SEC staff believes that for a fund with a March 31 fiscal year-end, incentive fees or allocations should be accrued on the statement of operations or statement of changes for the period from April 1 through March 31, even if the incentive fees or allocations are payable to the adviser or General Partner on December 31. Further, the SEC staff noted that when making fair value determinations of investee hedge funds, registered funds of hedge funds should consider whether the investee hedge funds properly accrue incentive fees or allocations.

.105 In addition, valuation due diligence for registered funds of hedge funds should be an ongoing and continual process. This process should be regularly evaluated so to ensure that, among other things, the investee funds are properly documenting and implementing the change of their policies, and whether those policies and procedures are in accordance with FASB ASC 946, *Financial Services—Investment Companies*.

.106 Frequently, registered funds of hedge funds will use the NAV of the investee hedge funds for valuation purposes. This is permissible under paragraphs 59–62 of FASB ASC 820-10-35 as a practical expedient. TIS sections 2220.18–.23 *(AICPA, Technical Practice Aids)* are intended to assist reporting entities when estimating the fair value of their investments in certain entities that calculate NAV. However, two conditions must be met for registered funds of hedge funds to use the practical expedient:

1. The NAV of the investee hedge fund must be calculated in a manner consistent with the measurement principles of FASB ASC 946.

2. The investee's NAV must be calculated as of the reporting entity's measurement date.

.107 FASB ASC 820-10-35-62 states that a reporting entity is not permitted to use the practical expedient if, as of the reporting entity's measurement date, it is probable that the reporting entity will sell the investment for an amount different from the NAV. The registrant should also have a policy to determine whether the registered fund should move off of the reported NAV and whether adjustments to the NAV should be made, for example if one of the two previous criteria is not met.

Principal Protection

.108 The SEC staff noted a fund that recently launched had a form of principal protection, which is provided by a third party. In those situations, the fund should consider whether the related contract providing the protection is a derivative that also needs to be fair valued and presented separately in the SOI.

Credit-Risk-Related Contingent Features

.109 FASB ASC 815-10-50-4H requires an entity that holds or issues derivative instruments to disclose all of the following for every annual and interim reporting period for which a statement of financial position is presented:

- The existence and nature of credit-risk-related contingent features
- The circumstances in which credit-risk-related contingent features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period
- The aggregate fair value amounts of derivative instruments that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period
- The aggregate fair value of assets that are already posted as collateral at the end of the reporting period
- The aggregate fair value of additional assets that would be required to be posted as collateral if the credit-risk-related contingent features were triggered at the end of the reporting period
- The aggregate fair value of assets needed to settle the instrument immediately if the credit-risk-related contingent features were triggered at the end of the reporting period.

.110 An example of a credit-risk-related contingent feature would be if the fund is required to accelerate payments to counterparties for derivatives in a net liability position when the fund's NAV decreases by a certain percentage.

.111 The SEC staff has observed varying levels of disclosure around these types of instruments in various registrants' financial statements. Certain registrants which met the disclosure requirements included discussion on the trigger features, and disclosed the purpose of the credit-risk-related contingent feature in plain English (for example, it will reduce the risk that the fund will not fulfill its payment obligations to counterparties). Other registrants provided general disclosure that there were derivatives with credit-risk-related contingent features but did not include all of the aforementioned disclosure requirements. The SEC staff observed other registrants with significant use of derivatives that did not have any disclosure of whether these were derivatives with credit-risk-related contingent features.

Gain Contingencies for Fair Fund Distributions

.112 A Fair Fund is a fund established by the SEC, in accordance with section 308 of the Sarbanes-Oxley Act of 2002, that distributes disgorgement (returns of wrongful profits) as well as any SEC imposed penalties to investors that may have been harmed as a result of fraud or misconduct. The SEC approves the creation of a Fair Fund as well as the distribution plan of the Fair Fund and ultimately makes distributions to the harmed investors. Before each distribution from the Fair Fund, the SEC publicly posts an order directing the disbursement of the Fair Fund on its website. Once the order is posted on the SEC's website, there could be a time lag between the date the order is posted and the actual date the cash is distributed.

.113 When funds qualify to receive Fair Funds distributions, such distributions represent gain contingencies. FASB ASC 450-30-25-1 states that a contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization. Therefore, funds generally do not record gain contingencies until cash is received. However, given the lag between the date the order is posted and the date the fund receives cash, the SEC staff is concerned that investors may try to market time the fund. This is because investors will know that once the fund receives the cash, the fund's NAV will increase as a result of recording the gain. The SEC staff has worked with registrants entitled to receive Fair Fund distributions to mitigate the risk of market timing through the consultation process. Upon consultation, the SEC staff has permitted registrants to reflect the Fair Fund distribution to be received in the NAV prior to the date the SEC publicly releases the order if the SEC staff is certain the order will be issued within a reasonable period of time. The SEC staff encourages registrants who are eligible to receive Fair Fund distributions to consult with the SEC staff regarding the appropriate timing of the gain recognition.

.114 The SEC staff commented that one situation occurred in which a fund did not consult with the SEC staff and recorded a gain contingency in its NAV prior to having certainty of receipt of a Fair Fund distribution. In this situation, the SEC staff expressed concern that the adviser earned management fees on assets that were not investable and that did not generate any income or return.

Expense Ratio

.115 Instruction 4(b) to Item 13(a) in Form N-1A explains the calculation of the expense ratio and references Rule 6-07 of Regulation S-X in determining which expenses are required to be presented in the statement of operations. Certain registrants present expense ratios in the financial highlights that do not include all of the expenses in the statement of operations; for example, some excluded interest expense, short dividend expense, and/or tax expense. The expense ratio must include all expenses in the statement of operations.

Derivatives

.116 In the SEC staff's July 2010 letter to the ICI related to derivative disclosures by investment companies, one item mentioned was the MDFP section of a registrant's annual report to shareholders which must include discussion on factors that materially affected the fund's performance during its most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund's investment adviser (as required by Item 27 of Form N-1A). The SEC staff continues to observe some registrants' filings in which the MDFPs are too vague. For example, certain MDFPs may indicate that funds use derivatives, but they do not elaborate on how derivatives contributed to or detracted from the fund's performance. Further, the SEC staff has observed filings in which the statement of operations reflects that a significant amount of income or loss from derivatives, but yet there is no discussion in the MDFP about the fund's use of derivatives.

Narrative Pro Forma Financial Statements

.117 The reporting of pro forma financial information in Form N-14 filings for investment company mergers is governed by Article 11 of Regulation S-X. Rule 11-02(b)(1) of Regulation S-X permits a narrative description of the pro forma effects of the transaction in lieu of condensed pro forma financial statements when there are a limited number of pro forma adjustments and those adjustments are easily understood.

.118 The SEC staff has recently given certain comments on registrants' narrative pro forma financial statements, including some instances when certain items are excluded from the narrative discussion. For example, there have been situations when registrants did not disclose the costs and tax implications of portfolio realignment. Also, some registrants include in the narrative description pro forma adjustments to fees and expenses as a result of the merger and disclose the pro forma adjustments as a dollar amount. However, by just showing the dollar amount, the actual impact is not put into perspective for shareholders. Therefore, a percentage impact of the pro forma adjustments should also be disclosed.

Advisory Contract Approval

.119 The SEC staff has observed that some funds are still using boiler-plate language when describing the investment advisory contract approval process as required by Item 27 (d) (6) page 60 of Form N-1A. The instructions there note that if any investment advisory contract is approved by the board of directors during the fund's most recent fiscal half-year, the fund should discuss in reasonable detail the material factors and the conclusions with respect thereto that formed the basis for the board's approval, in addition to other required disclosures. Registrants need to be specific in their disclosure and address all items required to be disclosed by Form N-1A. If a registrant could roll forward the disclosure from year to year, then it is probably too generic.

SEC Staff Comments and Observations

Disclaimer: The following comments and observations were compiled by the AICPA Investment Companies Expert Panel and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff. This is not intended to be a comprehensive list.

Custody Rule

Pooled Investment Vehicles—Defined Contribution Plans

.39 As discussed in question XII.1 of the SEC staff's custody rule FAQs, a related person of an investment adviser may act as the trustee of a participant-directed defined contribution plan established for the benefit of the adviser's employees. Further, as the trustee, this related person may select the service providers for the plan and may select the investment options available under the plan (for example, mutual funds). The assets of the plan do not need to be treated as client assets of which the adviser has custody in these circumstances solely because the related person of the adviser is trustee, provided that

- neither the investment adviser nor a related person otherwise acts as an investment adviser to the plan or any investment option available under the plan and
- the investment adviser and the related person trustee are, to the extent applicable, in compliance with the Employee Retirement Income Security Act of 1974 and rules and regulations issued there under with respect to the plan.

.40 However, the adviser is deemed to have custody of the plan when one of the plan's investment options is a pooled investment vehicle (PIV) managed by the adviser. The SEC staff indicated that, in this situation, all of the plan assets are subject to the custody rule as both the plan and the PIV are clients of the investment adviser.

Surprise Examinations—Date Selection

.41 An adviser subject to Rule 206(4)-2(a)(4) of the Advisers Act must have a surprise examination performed at least once during each calendar year with the first examination commencing within six months of the adviser becoming subject to the surprise examination requirement if the annual audit provision (as described in the rule release for the custody rule) is not utilized. If the adviser maintains client assets as a qualified custodian (QC), the adviser must receive a report on the internal controls of the QC within six months of becoming subject to the requirement, and the first surprise examination would need to occur no later than six months after obtaining the internal control report. Although question I.3 of the SEC staff's custody rule FAQs clarifies that a surprise examination must commence on or before the end of the 2010 calendar year, the SEC staff has pointed to footnote 37 of the SEC's adopting release and confirmed that Question I.3 was intended as transitional guidance for 2010 only. Three unique scenarios have been illustrated in the subsequent paragraphs to provide further clarification on surprise examination date selection.

.42 For example, the date selected for the surprise exam (that is, the "as of" date) for an adviser who registered with the SEC on October 31, 2012, and uses an independent QC should be no later than April 30, 2013. If the adviser is a QC and acting as a QC on behalf of the PIV, an internal control report must be received no later than April 30, 2013, and the date selected for the first surprise exam should be no later than October 31, 2013. In addition, the surprise examination should be completed within 120 days from the date selected. For the adviser that first became subject to the custody rule in October 2012, as long as the surprise examination occurs as of a date in 2013, no additional surprise examination would need to be performed until the calendar year 2014.

.43 An adviser to a PIV that registered with the SEC in January 2012 would satisfy the audit provision in Rule 206(4)-2(b)(4) of the Advisers Act and would not be required to have a surprise examination (assuming the PIV does not liquidate in 2012), if the following criteria are met:

- The financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP)

- A financial statement audit is performed by an independent public accountant (that is, an accountant that meets the standards of independence in Rule 2-01[b] and [c] under Regulation S-X) that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules as of the commencement of the professional engagement period and as of each calendar year-end

- The PIV distributes its audited financial statements within 120 days after the PIV's year-end (or, as described in Questions VI.8A and VI.8B of the SEC staff's custody rule FAQs, 180 days for a fund of funds or 260 days for a fund of fund of funds) to all limited partners (or members or other beneficial owners)

.44 If an adviser became subject to the custody rule when it launched a PIV in November 2012 and the adviser did not have an audit of the PIV performed as of December 31, 2012 (the PIV's year-end), but the date selected for the surprise examination occurred within six months (by May 2013), the PIV would not need an audit performed for 2013 for its adviser to satisfy the custody rule. However, if the adviser uses the 2013 surprise examination of the PIV to comply with the custody rule for 2012 and 2013 (as opposed to using the audit provision in Rule 206(4)-2(b)(4) of the Advisers Act), the adviser is required to

- comply with the notice requirements in Rule 206(4)-2(a)(2) of the Advisers Act and the account statement requirements in Rule 206(4)-2(a)(3) of the Advisers Act for that period; and

- use a QC to maintain the PIV's privately offered securities as per Rule 206(4)-2(b)(2)(ii) of the Advisers Act.

Annual Audit Provision

.45 In order to establish an interim program of inspection related to audits of brokers and dealers,[1] on July 18, 2011, Seward and Kissel LLP requested the SEC staff to provide guidance regarding the temporary rule adopted by the PCAOB on June 14, 2011. In light of the temporary rule, on July 21, 2011, the staff issued a no-action letter in response to Seward and Kissel LLP stating that it would not recommend enforcement action to the Commission under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder against an investment adviser who, for purposes of compliance with the custody rule, engages an auditor to (1) perform a surprise examination of an investment adviser who maintains, or who has custody because a related person maintains, client funds or securities as QC in connection with advisory services provided to clients, (2) prepare an internal control report, or (3) audit the financial statements of a PIV in connection with the annual audit provision, as long as such auditor was registered with the PCAOB and was engaged to audit the financial statements of a broker or a dealer as of the commencement of the professional engagement period of the respective engagement and as of each calendar-year end. This response applies until the earlier of the date the SEC approves a PCAOB-adopted permanent program for the inspection of broker and dealer auditors or December 31, 2013. [2]

529 Plans

.46 In a letter to the SEC requesting no-action assurances, the ICI expressed concern that certain registered investment advisers acting as a 529 plan's program manager may have custody for purposes of the custody rule. As a result, program managers would be required to undergo a surprise examination of those assets by an independent public accountant. The ICI requested that a 529 plan be treated as a PIV and exempted from the surprise examination, for purposes of the custody rule, as described in its request.

.47 The ICI represented that advisers to 529 plans could satisfy most of the conditions in paragraph (b)(4) of the custody rule and would provide 529 plan accountholders with comparable custody protections as holders of a PIV. For example, consistent with a PIV, the

---

[1] See PCAOB Release No. 2010-008, *Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers*, at pcaobus.org.

[2] This response will also cease to apply if the temporary rule is withdrawn or disapproved.

529 plan is subject to an annual financial statement audit by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB in accordance with its rules. The audit is conducted in accordance with generally accepted auditing standards (GAAS) and the audited financial statements are prepared in accordance with GAAP.

.48 On September 5, 2012, the SEC's Division of Investment Management staff issued a no-action letter in response to the ICI stating that it would not recommend enforcement action to the SEC against an investment adviser if the investment adviser treats the 529 plan for which it is a program manager as a PIV for purposes of the custody rule. As a result, the 529 plan assets would not be subject to an annual surprise examination, in reliance upon the following representations:

- The 529 plan is a college savings plan.
- The 529 plan's record-keeper is a registered transfer agent with the Commission under Section 17A of the Securities Exchange Act of 1934.
- The 529 plan's custodian(s) is a QC as such term is defined in Rule 206(4)-2(d)(6) under the Advisers Act.
- The assets of the 529 plan are subject to an annual audit as defined in Regulation S-X and the audit is conducted in accordance with GAAS.
- The 529 plan's annual audit is conducted by an independent public accountant that (1) is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules; and (2) meets the standards of independence in Rule 2-01(b) and (c) under Regulation S-X.
- The audited financial statements of the 529 plan are prepared in accordance with GAAP.
- The annual financial statements are provided annually to the state agency or instrumentality responsible for oversight of the 529 plan within 120 days of the end of the 529 plan's fiscal year.

- The annual financial statements are made available to all existing 529 plan account holders via the 529 plan's website.
- The program manager will ensure that the 529 plan account holders are provided written notification of the availability of the financial statements no later than the delivery of the account holders' next regularly scheduled quarterly account statement. Such notice may either be included with or on such statement or sent separately. The notice shall advise the account holder of a website where such financial statements may be accessed and provide the account holder information regarding how to contact the 529 plan to obtain a hardcopy of such financial statements in lieu of accessing them online. A hardcopy of the financial statements shall be provided by mail within three business days of an account holder requesting such copy.

.49 Users of this alert may access the full text of the ICI's incoming letter to the SEC and the SEC's no-action letter from the Division of Investment Management Staff No-Action and Interpretive Letters page at www.sec.gov.

Transitional Guidance

.50 Transitional guidance discussed in Section I, "Compliance Dates," of the SEC staff's custody rule FAQs is no longer available to registrants. Transitional guidance was only applicable for registered investment advisers who were subject to the rule at the rule's effective date (that is, March 12, 2010) and is not for registered investment advisers who become subject to it at some later date.

Auditor Independence

.51 On December 13, 2011, the SEC staff issued a joint set of responses related to auditor independence. The responses were added to the SEC Staff Responses to Questions About the Custody Rule web page on the SEC website at www.sec.gov and also at the Office of the Chief Accountant's FAQs page. The issues addressed in the FAQs include the following:

- *Prohibited nonaudit services*. Under the custody rule, an accountant performing a surprise examination must meet the standards of independence described in Rules 2-01(b) and (c) of Regulation S-X. According to the SEC's Release No. 33-

8183, *Strengthening the Commission's Requirements Regarding Auditor Independence*, there is a rebuttable presumption that certain prohibited nonaudit services (for example, bookkeeping or financial information systems design and implementation) will be subject to audit procedures during an audit of the client's financial statements. Rule 2-01(c)(4) provides that these nonaudit services are prohibited unless "it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements." It is the SEC staff's position that, subject to Rule 2-01(b) of Regulation S-X, an accountant performing a surprise examination under the custody rule would be able to perform certain nonaudit services as long as it is reasonable to conclude the following:

— The results of the nonaudit service will not be subject to attest procedures that might be performed during the surprise examination.

— The results of the nonaudit service would not be subject to audit procedures if the accountant had been engaged to perform a financial statement audit.

For example, if a PIV is included in the scope of an adviser's surprise examination under the custody rule, the accountant performing the surprise examination would be prohibited from compiling the PIV's financial statements.

- *Audit and professional engagement period*. For an adviser to comply with the custody rule, an accountant must be independent during the audit and professional engagement period when (*a*) performing a surprise examination of an adviser, (*b*) preparing an internal control report of an adviser's related person QC, or (*c*) performing an audit of a PIV's financial statements. The audit and professional engagement period applies to the previously mentioned engagements as follows:

  — For a surprise examination, the audit and professional engagement period begins the earliest of (*a*) the date the accountant signs an initial written agreement to perform the surprise examination, (*b*) the date the accountant begins attest procedures, or (*c*) the beginning of the period subject to the surprise examination.

— For the preparation of an internal control report or an audit of a PIV's financial statements, the audit and professional engagement period begins the earliest of (*a*) the date the accountant signs an engagement letter or other agreement to prepare the QC's internal control report or audit the PIV's financial statements, (*b*) the date the accountant begins attest or audit procedures, or (*c*) the beginning of the period covered by the internal control report or the PIV's financial statements.

- *End of engagement period*. In general, the audit and professional engagement period for the surprise examination ends when the accountant notifies the SEC of its termination pursuant to the custody rule. The audit and professional engagement period for the preparation of an internal control report or for the audit of a PIV's financial statements ends when the audit client or the accountant, as applicable, notifies the other that the client is no longer the accountant's client for such engagement.

- If the auditor is notified prior to issuing their surprise examination report, internal control report, or PIV audit report that they will not be engaged to perform the next respective surprise examination, prepare the next respective internal control report, or perform the next respective PIV audit, then the professional engagement period ends with the issuance of the accountant's report for that particular engagement. It is important to note, however, that even when the termination of the professional engagement period is not effective until a future date or event, the obligation to make a filing under SEC regulations upon notification is not affected (for example, a filing on Form ADV-E for the surprise examination).

Consolidation of Nonregistered Entities

.52 Concerns have been raised over the challenges of interpreting the literature in Regulation S-X, which indicates that a registered investment company may consolidate only the financial statements of an investment company. The SEC staff noted that, as described in Rule 3A-02 of Regulation S-X, there is an overall presumption that consolidated financial statements are more meaningful than separate statements. Registrants are reminded to consider the substance as well as the form of the relationship between the investment company and the nonregistered investment entity (for example, blocker or special purpose vehicle, as appropriate) and whether consolidation more appropriately reflects the overall financial position and results of operations. The SEC staff has not objected when an investment company consolidates a wholly owned blocker (see for example, no-action letter to Fidelity Select Portfolio dated April 29, 2008, on the SEC website at www.sec.gov). Furthermore, when investment companies invest in wholly owned or substantially-owned nonregistered investment entities, the SEC staff noted that generally consolidation would provide the most meaningful financial statement presentation and is an effective way to provide transparency. Registrants are encouraged to consult with the SEC staff on particular fact patterns that pertain to blocker entities and wholly owned or substantially-owned entities.

Issues of Interest

.53 The staff in the Division of Investment Management occasionally identifies issues under the 1940 Act, the Advisers Act, or other federal securities laws that may benefit from being highlighted generally for investment companies, investment advisers, and their counsel. Selected issues of interest are highlighted herein. Users of this alert may access the complete listing of issues of interest, as well as their summaries, from the Investment Management Staff Issues of Interest page at www.sec.gov. The summaries are not intended as a comprehensive summary of all legal and compliance matters pertaining to the topics discussed herein. Rather, these responses are intended as general guidance and should not be relied on as definitive. The summaries are not rules, regulations, or statements of the SEC, and the SEC has neither approved nor disapproved these summaries.

BDCs—Auditor Verification of Securities Owned

.54 The SEC staff posted an issue of interest relating to auditor verification of securities owned by BDCs. Under Section 30(g) of the 1940 Act and the Commission's Accounting Series Release No. 118 (Dec. 23, 1970), the certificate of independent public accountants (auditor) contained in the financial statements of investment companies registered under the 1940 Act must include a statement, "that such independent public accountants have verified securities owned, either by actual examination, or by receipt of a certificate from the custodian." Although Section 59 of the 1940 Act does not make Section 30(g) applicable to BDCs, a BDC's auditor plays an important role under the 1940 Act in preventing a BDC's assets from being lost, misused, or misappropriated. Therefore, the SEC staff believes that it is best practice for a BDC to have its auditor verify all of the securities owned by the BDC, either by actual examination or by receipt of a certificate from the custodian, and affirmatively state in the audit opinion whether the auditor has confirmed the existence of all such securities.

Funds Using Tender Option Bond Financings

.55 An open-end or closed-end investment company registered under the 1940 Act may seek to arrange a secured financing through a special purpose trust (tender option bond [TOB] trust). In this arrangement, the investment company deposits a tax-exempt or other bond into the TOB trust. The TOB trust issues two types of securities—floating rate notes (floaters or TOBs) and a residual security junior to the floaters (inverse floater). The TOB trust sells the floaters to money market funds or other investors and transfers the cash proceeds and the inverse floater to the fund. The investment company typically purchases additional portfolio securities with the cash proceeds. The inverse floater entitles the investment company to any value remaining after the TOB trust satisfies its obligations to the TOB's holders and allows the investment company to call in the floaters and collapse the TOB trust. A third party liquidity provider guarantees the TOB trust's obligations on the floaters.

.56 This arrangement involves borrowing by the investment company and implicates Section 18 of the 1940 Act, which prohibits an open-end fund from issuing any senior security, except for borrowing from a bank with 300 percent asset coverage, and generally requires a closed-end fund to have 300 percent asset coverage for any senior security that represents an indebtedness. Section 18(g) generally defines a *senior security* as any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and provides that senior security representing indebtedness means any senior security other than stock. The staff has addressed TOB financings under Section 18 on multiple occasions in reviewing investment company registration statements and in the context of other communications with various investment companies and their counsel. In particular, the staff's position is that a TOB financing involves the issuance of a senior security by an investment company unless the investment company segregates unencumbered liquid assets (other than the bonds deposited into the TOB trust) with a value at least equal to the amount of the floaters plus accrued interest.

Investments in Nonregistered Unconsolidated Entities—Disclosure Requirements

.57 Funds are making significant investments in nonregistered investment entities. For example, certain mutual funds employ some type of alternative investment strategy, such as managed futures funds, that invest in nonregistered investment companies or investment entities. Similarly, BDCs invest in nonregistered investment companies or other entities. If a fund's or BDC's investment in an unconsolidated entity exceeds certain thresholds, the SEC staff expects the audited financial statements of the unregistered unconsolidated entity to be included with the fund's or BDC's filing.

.58 Rule 3-09 of Regulation S-X describes requirements for when separate financial statements of a significant subsidiary (for example, unconsolidated nonregistered investment company) should be provided with the reporting fund. Rule 3-09 refers to the three tests included in Rule 1.02(w) of Regulation S-X (substituting 20 percent for 10 percent) to determine whether the investee is a significant subsidiary and whether to include separate financial statements of the significant subsidiary. When performing the tests in Rule 1.02(w), the rule requires the use of amounts determined under GAAP, which would include consolidation of underlying subsidiaries as necessary or applicable. Pursuant to Rule 3-09, generally, the separate financial statements required must be audited. Rule 3-09 also explains that, insofar as practicable, the separate financial statements required should be as of the same dates and for the same periods as the reporting fund. The separate financial statements should be prepared in accordance with Regulation S-X, including a schedule of investments with the same level of detail as for the registrant (for example, presenting a complete schedule of investments rather than a condensed schedule of investments).

.59 The SEC staff discussed that when a registered fund or BDC invests 25 percent or more of its net assets in a nonregistered investment company or entity, the fund or BDC should provide the underlying entity's audited financial statements. The underlying entity's financial statements should be prepared in accordance with Regulation S-X, including a schedule of investments with the same level of detail as the registered fund (for example, presenting a complete schedule of investments rather than a condensed schedule of investments).

.60 The SEC staff stated that if a subsidiary is not consolidated and it does not meet the criteria to attach the financial statements previously described, registrants should consider whether summarized financial information should be included in the notes to the financial statements based on Rule 4-08(g) of Regulation S-X. Rule 4-08(g) requires disclosure in the notes to the financial statements of a summarized balance sheet and income statement. Rule 1-02(bb) of Regulation S-X, which contains the requirements for the summarized financial information, allows for the use of more meaningful information in the summarized balance sheet and income statement for specialized industries, such as investment companies. Rule 4-08(g) explains that, insofar as practicable, the summarized financial information should be as of the same dates and for the same periods as the reporting fund.

.61 Registrants are encouraged to consult the SEC staff on the accounting and disclosure requirements for funds' and BDCs' investments in nonregistered unconsolidated entities.

Asset Test Under Rule 3-09 of Regulation S–X

.62 As previously noted, when performing the asset test under Rule 3-09 of Regulation S-X (which is one of the three tests indicated in Rule 1-02[w] to determine whether the financial statements of a majority-owned subsidiary, which is not consolidated, should be filed along with the registrant's filing with the SEC [see Rule 1-02(w)(2)]), a registrant should perform the test using financial information for both the registrant and its subsidiaries prepared in accordance with GAAP, including the consolidation of other subsidiaries as necessary or applicable. Under the asset test, if the registrant's proportionate share of the total assets of an unconsolidated majority-owned subsidiary exceeds 20 percent of the total assets of the registrant and its subsidiaries consolidated, as of the end of the most recently completed fiscal year, the financial statements of the unconsolidated majority-owned subsidiary should be filed with the registrant's financial statements.

.63 The SEC staff noted a case in which a BDC held an investment in a wholly owned investment adviser that managed a portfolio of collateralized loan obligations (CLOs). In this case, the BDC determined that the wholly owned adviser was required to consolidate several of the CLOs in accordance with GAAP. Therefore, the BDC concluded that the BDC's proportionate share of the wholly owned adviser's consolidated total assets (which included consolidation of the CLOs) was greater than 20 percent of the BDC's total assets. As a result, the BDC concluded that it was required to file the consolidated financial statements of its wholly owned adviser in its periodic filings with the SEC.

BDCs

.64 The SEC staff noted the following related to their recent financial statement review of BDCs:

- *Form N2 disclosure requirements.* BDCs should provide the disclosures regarding investments not qualifying under Section 55(a) of the 1940 Act in the Schedule of Investments in registration statements and periodic filings with the SEC required by Item 8.6c, instruction 1.b to Form N-2. In general, BDCs are required to identify the nonqualifying investments and, in a footnote, briefly explain the significance of the nonqualification.

- *Payment-in-kind interest*. For securities that pay a combination of cash and payment-in-kind (PIK) interest, some BDCs have reported the interest rate on these securities as the combination of the two rates and did not disclose that a portion of the interest is PIK. The SEC staff noted that registrants should disclose the portion of interest that is PIK and may also consider disclosing both the cash and PIK rates in the Schedule of Investments or in a footnote thereto.

  The SEC staff observed that a BDC accrued interest income on a PIK security, thereby increasing the cost basis of the security; however, the valuation of that PIK security remained unchanged. This resulted in the BDC recording interest income and a decrease in change in unrealized gain or loss, and had a net impact of zero on the income statement; however, incentive fees were earned on the investment income component. Given that the cost was increased with no increase to valuation, the SEC staff questioned whether the valuation of the security was appropriate, and whether the PIK income should have been accrued.

  The SEC staff observed that the accrual of noncash PIK income was a significant portion of total interest income accrued during the period for certain BDCs. Generally, these BDCs included the accrued noncash PIK income as a separate line item in the reconciliation to net income within the operating activities section of the statement of cash flows. However, certain BDCs did not disclose accrued noncash PIK income separately and instead aggregated it within another line item in the statement of cash flows. Therefore, the SEC staff reminded these BDCs to disclose the accrued PIK income as a separate line item in the statement of cash flows.

- *Acquired fund fees and expenses.* If a mutual fund invests in a BDC, the mutual fund should include the BDC's fees as Acquired Fund Fees and Expenses in the fee table in the prospectus. The SEC staff referred to Question 1 within the *Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses* on the SEC's website.

MDFP and the Use of Derivatives

.65 The SEC staff continues to notice that some MDFPs do not clearly elaborate when derivatives materially affect the fund's performance. In her speech on November 17, 2011, at the ICI 2011 Closed-End Fund Conference (http://sec.gov/news/speech/2011/spch111711epr.htm), Eileen Rominger, then the Director of the Division of Investment Management, reiterated the importance of describing in the annual report any material effect of derivatives or leverage on the performance of the fund.

.66 The SEC staff observed that in some situations, the manager does not separate derivatives performance by fund but rather has an overall derivative strategy for all funds in the investment company complex, or the manager does not track derivative performance separately from the rest of the portfolio, for each fund. However, Item 27(b)(7)(i) of Form N-1A requires each fund's MDFP to include a discussion of the factors that materially affected the fund's performance during the most recently completed fiscal year, including the relevant market conditions and investment strategies and techniques used by the fund's adviser.

Post–Effective Amendments to Registration Statements and Updated Consents

.67 The SEC staff commented that whenever a post-effective amendment to a registration statement either includes an auditor's report or incorporates by reference an auditor's report, the written consent of the auditors must be filed as an exhibit to the registration statement. In addition, consents may not be incorporated by reference from a prior filing, even if the financial statements and auditor's report are incorporated by reference. For example, when a post-effective amendment filed in December 2011 incorporated by reference the auditor's consent dated April 2011, the SEC staff's view was that an updated auditor's consent should have been included in the filing.

Managed Futures Funds

.68 The SEC staff provided the following observations regarding managed futures funds, which may also be applicable to other types of funds:

- *Expense ratios*. Some managed futures funds are invested in wholly owned, non-SEC registered Cayman Islands tax blockers (Cayman Blocker), which are consolidated in the fund's financial statements. The SEC staff provided an example in which the fund's financial highlights presented 2 sets of expense ratios (including and excluding expenses of the consolidated Cayman Blocker) with equal prominence. Because the fund owns 100 percent of and consolidates the Cayman Blocker, this presentation may be misleading. Therefore, the SEC staff noted that the expense ratio including the expenses of the consolidated Cayman Blocker should have been presented with greater prominence in the financial highlights.

- *Fair value measurement disclosures*. Some funds invested in underlying funds that were neither wholly owned nor consolidated; however, the notes to the financial statements did not include disclosure on how the investments in those underlying funds were being valued, such as whether the funds were using the practical expedient per FASB ASC 820, *Fair Value Measurement*, to value the investments in those underlying funds. In these situations, the SEC staff reminded funds about the requirements of including a discussion on valuation of these investments in underlying funds and providing disclosures in accordance with FASB ASC 820-10-50-6A, such as any restrictions on redemptions from the underlying funds.

- *Total return swaps*. Funds investing in total return swaps (and other derivatives) should disclose the notional amount and identify the counterparty(ies) to the swaps (and other derivatives) as part of the description of the derivative in the financial statements.

Funds of Funds or Feeder Funds with a Significant Investment

.69 The SEC staff observed that a registered investment company structured as a fund of funds invested a very significant amount of its net assets (for example, 80 to 90 percent) into one underlying fund, but did not include the financial statements of the underlying fund in filings with the SEC or on its website. Consistent with ASC 946-210-45-7, if an investment in another fund is so significant, the registrant should consider attaching financial statements of the underlying fund, consistent with master-feeder financial statement presentation. Further, if the registrant's investments in the underlying fund were presented as Level 1 in the fair value hierarchy, whereas the underlying fund's portfolio contained mostly Level 3 securities, it may be misleading. Therefore, funds following this fact pattern should include supplemental disclosure such as noting the underlying fund's portfolio consists mostly of Level 3 securities and refer to the fair value hierarchy in the attached financial statements of the underlying fund. Alternatively, the fund could include the underlying fund's fair value hierarchy in its financial statements. Further, the December 2008 EP meeting highlights states, in part, that the SEC staff "would not object if the feeder fund either refers to the financial statements of the master fund in its financial statements or presents the [master fund's] 'level' disclosure in its own financial statements."

Form N-14

.70 The SEC staff noted the following comments related to recently submitted Form N-14:

- *Pro forma narratives.* In accordance with Rule 11-02(b) of Regulation S-X, registrants may include a narrative description of the pro forma effects of the merger in lieu of financial statements in certain circumstances (that is, where a limited number of pro forma adjustments are required and those adjustments are easily understood). The SEC staff has rejected narrative pro forma presentation for complex mergers that did not meet the criteria in Rule 11-02(b). To the extent that a registrant has questions on whether narrative descriptions can be used in lieu of pro forma financial statements, registrants are encouraged to contact the SEC staff.

- *Accounting survivor analysis.* The SEC staff may request an analysis of the determination of the survivor entity for accounting, performance, and financial reporting purposes. If an entity that has limited operations (for example, a shell company) is merging with another entity with established operations, the entity with limited operations should generally not be deemed the accounting survivor. The concern is that the poor performance track record for the established fund could be eliminated by merging it into a fund with limited operations, which is then deemed the survivor, resulting in past poor performance of what is in substance the same entity not fully disclosed to shareholders. See also paragraph 8.44 of the 2012 AICPA Audit and Accounting Guide *Investment Companies* for additional information.
- *Significant redemptions subsequent to the "as of" date.* When there are significant redemptions that occur after the date of the pro forma financial statements, fee table, and capitalization table that are included in Form N-14 filings, the SEC staff requests that registrants show the impact of the significant redemptions on the pro forma financial statements, fee table, and capitalization table.

Third-Party Pricing Services

.71 As stated in remarks by a staff member of the SEC's Office of the Chief Accountant in a speech before the AICPA National Conference on SEC and PCAOB Developments in December 2011, third party pricing services can often be used by management of public companies to obtain information to assist them with management's responsibilities for estimating and disclosing the fair value of financial instruments in their financial statements. The SEC staff reminded management of its obligations, including when it uses third party pricing service information to (*a*) comply with GAAP, including disclosure requirements; (*b*) maintain appropriate internal controls to prevent or detect material misstatements; and (*c*) assess internal control over financial reporting. Each of the points is discussed in further detail in the SEC staff's speech, which can be accessed from the *Commission Speeches and Public Statements Archive: 2011* page at www.sec.gov.

.72 In connection with financial statement reviews, the SEC staff may ask registrants questions related to the use of pricing services in complying with the accounting and disclosure requirements in the financial statements.

Expense Limitation Agreements

.73 According to the guidance in FASB ASC 946-20-05-8, some expense limitation agreements may provide that reimbursements by the fund adviser of expenses incurred by the fund in excess of the maximum permitted by the prospectus or offering document will be carried over to a future period and reimbursed to the fund adviser when, and to the extent that, the total expense ratio falls below the permitted maximum. Such agreements may provide that reimbursement of excess expenses to the fund adviser is not required after a specified date or upon conclusion of a specified period from the time the fund initially incurred, or the adviser initially reimbursed, the expenses, such as three years.

.74 The SEC staff reminded registrants that if an adviser is waiving fees, but recoupment is probable, the fund would need to accrue an expense to reflect the recoupment which would offset the benefit of a current year's waiver.

Expense Ratios

.75 In recent financial statement reviews, the SEC staff made comments about the inclusion of numerous expense ratios in the body of the financial highlights. When too many different expense ratios are presented in the financial highlights, the disclosure may become cluttered and difficult for shareholders to understand. The SEC staff commented that they would prefer seeing the ratio of all expenses, as included in the Statement of Operations, to average (common share) net assets (gross expense ratio) and net expenses to average (common share) net assets as the primary ratios presented within the financial highlights. If appropriate, other ratios may be included in a footnote to the financial highlights in order for them to have less prominence in the table.

Form N-MFP Observations

.76 Rule 30b1-7 of the 1940 Act requires every registered open-end management investment company, or series thereof, that is regulated as a money market fund under Rule 2a-7 of the 1940 Act to file with the SEC a monthly report of portfolio holdings on Form N-MFP, as of the last business day of the previous month. This must be filed no later than the fifth business day of each month. The SEC will make the information filed on this form available to the public 60 days after the end of the month to which the information pertains.

.77 The SEC staff noted the following comments related to recently submitted Forms N-MFP:

- When the fund or class is dissolved during the month, Form N-MFP should still be completed, even if there are limited operations. The SEC staff has noted in these instances it would be acceptable to answer many of the questions as “not applicable.”
- Item 7 requires the registrant to disclose if the fund is a feeder fund. However, the disclosures within Item 7 should pertain to the master fund that the feeder is invested in, not the feeder fund itself.
- Items 26–27 and 37–39 call for identification of the issuer, the issuer’s title, and any providers of demand features, guarantees, or other types of enhancement providers. When providing the required disclosures, complete names for that information should be furnished rather than acronyms or ticker symbols.
- Item 31 requires registrants to indicate categories of investments. Certain registrants have been miscategorizing Treasury repurchase agreements (repos). To be classified as a Treasury repo, the repo should be fully collateralized by Treasury securities and cash; no other security types should be utilized. If any security other than a Treasury or cash is used as collateral, the repo should not be categorized as a Treasury repo. Government National Mortgage Association securities are not Treasuries, as they are Government/Agency securities. The category for “Government/Agency Repo” means “Government/Agency or better.” If a repo is collateralized by government securities and Treasury securities, it is a “Government/Agency Repo,” not an “Other Repo.” The category for “Other Repo” should be used only when the collateral for the repo includes securities other than Treasuries and government/agency securities and cash.
- When completing Item 32, entities should disclose information related to the collateral of the repo rather than the counterparty of the repo. The collateral for every repo must be entered, whether or not the fund is looking through to the collateral for diversification purposes.
- As previously addressed, Form N-MFP must be filed no later than the fifth business day of each month unless the business day is a federal holiday. For example, one third of money market funds did not file Form N-MFP on Good Friday, which happened to occur on the fifth business day in April 2012.

Although stock markets were closed on this day, Good Friday is not a federal holiday and, therefore, Form N-MFP should have been filed.

Risk/Return Summary: Fee Table

.78 The SEC staff has observed diversity in practice regarding fee table presentation in Form N-1A when a fund consolidates a wholly owned subsidiary. Some registrants are including the subsidiary's expenses in Acquired Fund Fees and Expenses (AFFE), whereas other registrants are retaining the character of the subsidiary's expenses. Registrants are reminded of instruction 3 to Item 3 of Form N-1A and should note in such cases that the character of the expense at the subsidiary level should be retained when populating the fee table in Form N-1A, as the subsidiary is consolidated (that is, do not include the consolidated subsidiary's expenses in AFFE).

Credit-Risk-Related Contingent Feature Disclosure Requirements

.79 The SEC staff observed that certain funds are not including all required credit-risk-related contingent feature disclosure requirements identified in FASB ASC 815, *Derivatives and Hedging*. In accordance with FASB ASC 815-10-50-4H, an entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 58 and 66 of FASB ASC 815-20-25) should disclose all of the following for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented:

- The existence and nature of credit-risk-related contingent features
- The circumstances in which credit-risk-related contingent features could be triggered in derivative instruments (or such nonderivative instruments) that are in a net liability position at the end of the reporting period
- The aggregate fair value amounts of derivative instruments (or such nonderivative instruments) that contain credit-risk-related contingent features that are in a liability position at the end of the reporting period
- The aggregate fair value of assets that are already posted as collateral at the end of the reporting period
- The aggregate fair value of additional assets that would be required to be posted as collateral if the credit-risk-related contingent features were triggered at the end of the reporting period

- The aggregate fair value of assets needed to settle the instrument immediately if the credit-risk-related contingent features were triggered at the end of the reporting period

.80 The SEC staff noted inconsistency in funds' disclosures regarding credit-risk-related contingent features contained in counterparty agreements that could cause the registrant to be required to settle derivatives that are in a liability position. The SEC staff noted that although some registrants made disclosures of the existence and nature of the credit-risk-related contingent features and the circumstances in which credit-risk-related contingent features could be triggered (for example, a certain percentage decrease in the fund's net assets or net asset value per share), some registrants did not include quantitative disclosures required by paragraph FASB ASC 815-10-50-4H (c–f). Registrants are reminded that quantitative disclosures should be included in the notes to the financial statements under the guidance in FASB ASC 815-10-50-4H. Registrants are also reminded to carefully evaluate counterparty agreements in order to identify all features that are required to be disclosed.

Credit Valuation Adjustments

.81 Registrants are reminded that credit valuation adjustments (CVAs) are a required part of fair value measurements and should be considered, including situations when registrants use quotes from brokers or pricing services, in developing fair value measurements for derivative assets and liabilities. The SEC staff referred registrants to the 2008 Dear CFO Letter issued by the Division of Corporation Finance, which reminded registrants to consider including disclosures about how credit risk affected the valuation of derivative assets and liabilities.

Enforcement

.82 The SEC staff commented that themes of valuation cases involving mispricing of securities include

- ignoring available dealer quotes and other market information that would have negatively impacted pricing;
- using prices provided by third party pricing services or broker-dealers that did not appear to take recent transactions into account;

- stale pricing and no periodic re-evaluation of prices;
- lax valuation committees resulting in portfolio managers having too much influence over valuation;
- ignoring third party quotes and using unsubstantiated price adjustments; and
- failing to comply with disclosed internal valuation procedures for the valuation of illiquid securities.

.83 The SEC staff provided examples of themes of enforcement cases when there are frauds or intentional misstatements. The examples include the following:

- Fraud or intentional misstatements might occur through related party transactions
- Fraud or intentional misstatements might occur to hide poor performance
- An adviser might commit fraud because he or she is in poor financial condition, has been experiencing operating losses, and needs cash to sustain operations or to pay expenses
- Fraud or intentional misstatements might be committed through a series of complex transactions which are difficult to understand and have no substantive business purpose

SEC Staff Comments and Observations

.41 *Disclaimer*: The following comments and observations were compiled by the AICPA Investment Companies Expert Panel (Expert Panel) and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff. This is not intended to be a comprehensive list.

SEC Division of Investment Management's Financial Statement Reviews

Overview

.42 In accordance with Section 408(c) of the Sarbanes-Oxley Act of 2002 (SOX), at least once every three years the SEC staff reviews filings, including financial statements of all issuers (registered investment companies and business development companies [BDCs] are included). The SEC staff has noted there may be instances when funds are reviewed more frequently than once every three years. For example, a fund that was selected for a targeted review (for example, based on new products or emerging areas in the market) may also be selected for a full SOX review.

.43 The SEC staff in the Division of Investment Management consists of 10 accountants, including 2 who specialize in insurance products. The accountants review annual financial statements (and may also review semiannual financial statements) and other filings, such as N-Qs, N-14s, and any other filing on the SEC's website. The accountants also review the registrant's website to ensure what is depicted on the registrant's website is consistent with what is filed with the SEC. The SEC staff generally provides their financial statement review comments verbally, and registrants are generally required to respond in writing within 30 days. Generally, comment letters and response letters between the SEC staff and the registrant will be disseminated to the public at least 20 days after the completion of the review.

.44 The SEC staff has communicated the following financial statement review comments during Expert Panel calls and meetings:

ASU No. 2011-04

.45 The SEC staff has observed the following review findings pertaining to the adoption of ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*:

- The SEC staff has observed the use of wide ranges of unobservable inputs in the tabular disclosures required by ASU No. 2011-04. During certain reviews, when the registrants used discounted cash flow models as the valuation technique and the registrants' disclosures reflected a wide range of discount rates being used, the registrants were asked to provide a weighted average range of the discount rate prospectively. This is consistent with the illustrative disclosure included in paragraph 103 of FASB ASC 820-10-55.
- The SEC staff has referred to the SEC's Division of Corporation Finance (SEC Corp Fin) staff remarks at the 2012 AICPA National Conference on Banks & Savings Institutions regarding the use of multiple valuation techniques for certain classes of instruments, when such valuation techniques are not bifurcated by fair value under each valuation approach. The SEC staff provided an example of a BDC with senior debt classified as level 3 in the fair value hierarchy, when both a discounted cash flow valuation technique and a market comparable valuation technique were used for different holdings within senior debt. Although the BDC did disclose each valuation technique, it only provided total fair value for the total senior debt and did not separately disclose the fair value derived from the discounted cash flow technique and the fair value derived from the market comparable technique. SEC Corp Fin's remarks are available at http://sec.gov/news/speech/2012/spch091212sc.pdf.
- Some practitioners may observe that the example quantitative disclosure table included in FASB ASC 820-10-55-103 shows a security type with two valuation techniques, and the fair value is not bifurcated between the two techniques. Practitioners may also be concerned that extensive and detailed disclosure information at a disaggregated level may not be useful to readers of financial statements because individual level 3 investments may be immaterial in relation

to total assets or total level 3 assets. In response to such practitioner concerns, the SEC staff explained that the answer depends on facts and circumstances and noted guidance in paragraph BC86 of ASU No. 2011-04, which states, in part, that the objective of the disclosure is not to enable users to replicate values but to provide enough information to the users to assess whether the reporting entity's views are significantly different from their own and, if so, to decide how to incorporate the reporting entity's fair value measurement in their decisions.

- The SEC staff has noted that there appears to be diversity in practice regarding the extent of significant unobservable inputs included in quantitative disclosures required by paragraph 2(bbb) of FASB ASC 820-10-50. The SEC staff provided an example of two funds within different fund complexes, each holding a similar investment, in which a discounted cash flow model was indicated as a valuation technique. One fund disclosed only the discount rate as a significant unobservable input, whereas the other fund included additional significant unobservable inputs, such as growth rate, recovery rate, and so on, along with the discount rate. The SEC staff reminded registrants that quantitative information about all significant unobservable inputs used in the calculation of fair value should be disclosed.
- The SEC staff has observed that certain funds did not disclose the valuation process for level 3 measurements in the footnotes to the financial statements, as required by paragraph 2(f) of FASB ASC 820-10-50. The SEC staff noted that this disclosure should be included in the audited section of the financial statements (footnotes to the financial statements), rather than in the Management's Discussion of Fund Performance (or Management's Discussion & Analysis for BDCs).
- The SEC staff has observed that some investment companies were not disclosing a description of the interrelationship of unobservable inputs used and how those interrelationships may magnify or mitigate the effect of changes in the unobservable inputs on fair value. Disclosure of this interrelationship is required by paragraph 2(g) of FASB ASC 820-10-50 for public entities, such as registered investment companies and BDCs.

.46 Practitioners should consider these financial statement review comments when preparing, reviewing, or auditing the FASB ASC 820, *Fair Value Measurement*, disclosure requirements. For an additional resource, practitioners may refer to the 2013 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the investment company guide), which contains ASU No. 2011-04 implementation guidance and best practices, as well as illustrative financial statement disclosures.

BDC Observations

.47 The SEC staff has observed the following review findings pertaining to business development companies:

- Rule 3-09 of Regulation S-X describes requirements when separate financial statements of a majority-owned unconsolidated significant subsidiary should be filed by a registrant. Rule 3-09 refers to the three tests described in Rule 1-02(w) of Regulation S-X, substituting 20 percent for 10 percent, to determine whether the investee is a significant subsidiary for purposes of Rule 3-09. When performing the tests in Rule 1-02(w), as described in the note to paragraph (w), Regulation S-X requires the use of GAAP financial statements, which would include the consolidation of any underlying subsidiaries if required under GAAP. Rule 3-09 describes the circumstances under which the separate financial statements required must be audited. It also explains that, insofar as is practicable, the separate financial statements required should be as of the same dates and for the same periods as the registrant. The separate financial statements of an unconsolidated significant subsidiary that is an investment company, for accounting purposes, should be prepared in accordance with Regulation S-X, which would include a full schedule of investments.

  The SEC staff observed a recent BDC registration in which the BDC had a wholly-owned subsidiary, which was a collateralized loan obligation (CLO). The BDC's management concluded that the CLO triggered one of the significant subsidiary tests in Rule 1-02(w), and audited financial statements of the CLO should be filed by the BDC pursuant to Rule 3-09. Instead of filing the CLO's audited financial statements, the BDC included the CLO's financial statements without the audit opinion in a footnote to the BDC's financial statements and marked the footnote as unaudited. The SEC staff indicated when a BDC triggers Rule 3-09 and is required to file audited financial statements of the significant subsidiary, the subsidiary's financial statements should be filed under either Item 8 or Item 15 of Form 10-K and should not be included in an unaudited footnote to the registrant's financial statements.

Moreover, when a registrant is required to file the financial statements of an unconsolidated majority-owned subsidiary under Rule 3-09 but the financial statements of the majority-owned subsidiary will not be filed until after the original due date of the registrant's Form 10-K, the registrant must include Rule 4-08(g) summarized financial information in its audited financial statements. This is described in section 2420.5 of the SEC *Corporation Finance Financial Reporting Manual*.

When a registrant with a significant subsidiary is required by Rule 4-08(g) of Regulation S-X to include summarized financial information in the notes to the registrant's financial statements, the SEC staff indicated that it is acceptable to file separate audited financial statements of the significant subsidiary that are compliant with U.S. GAAP and Regulation S-X in lieu of the summarized financial information. Guidance in the SEC Staff Accounting Bulletin Topic 6.K should be considered in such situations.

Practitioners should also refer to the Investment Management Guidance Update No. 2013-07, which was released in September 2013 and is available on the Division of Investment Management website. It provides additional discussion of the aforementioned reporting requirements and how they should be applied by BDCs. The guidance update states that Rules 3-09 and 4-08(g) apply to BDCs. The guidance update also explains that if a BDC is required to present summarized financial information pursuant to Rule 4-08(g), the Division of Investment Management generally would not object if the BDC presents summarized financial information in the notes to the financial statements only for each unconsolidated subsidiary that individually meets the definition of a significant subsidiary in Rule 1-02(w) but does not present summarized financial information in the notes to the financial statements for all unconsolidated subsidiaries. As practitioners consider the provisions in this guidance update, they are also reminded that it is inappropriate for an entity to structure their investment positions in order to avoid compliance with the meaning of the rules. If a BDC believes the application of Rule 3-09 or Rule 4-08(g) results in the presentation of either financial statements or summarized financial information of an unconsolidated subsidiary that is not necessary to reasonably inform investors, the BDC should contact the Division of Investment Management's Chief Accountant's Office at 202.551.6918 or imoca@sec.gov.

- The SEC staff has observed instances in which BDCs and registered investment companies are formed by acquiring partial portfolios of private funds or by acquiring entire private funds (either before or after the effectiveness of the initial registration statements) to the extent permitted under the Investment Company Act of 1940 (the 1940 Act). In such instances, questions arise about whether the private fund's financial statements or other information should be included in the registration statement. The SEC staff explains that when an entity is determining what information may need to be included, registrants should ensure, among other things, that investors of the existing private fund(s) do not have more recent and relevant information than potential investors of the new registrant about the product being offered.

  Generally, the SEC staff's position is that if a BDC or registered investment company acquires (or if it is probable, the registrant will acquire) a significant portion of a private fund, an entire private fund, or multiple private funds, at least two years of audited Regulation S-X and U.S. GAAP compliant financial statements of the private fund(s) should be included in the registration statement (including a full schedule of investments, as opposed to a condensed schedule of investments). In certain circumstances, the SEC staff may also request unaudited interim financial statements of the private fund(s), seed financial statements, pro forma financial statements, an audited special purpose schedule of investments to be acquired, and/or supplemental information that has been provided to private fund investors. In addition, there may be circumstances when additional narrative information regarding the adviser's decision to select a private fund(s) or a significant portion of a private fund(s) to be acquired should be disclosed. The aforementioned narrative disclosure should be similar to what is described in item (*d*) of the subsequent paragraph. The SEC staff may also request management representations regarding any material changes in the fair value of any investment since the date of the last audited or interim financial statements presented in the filing, similar to what is described in item (*e*) of the subsequent paragraph.

If a BDC or registered investment company is going to acquire a small portion of a private fund's assets or small portions of assets of multiple private funds, then the SEC staff generally would not object to the registrant including, in lieu of audited private fund financial statements, an audited special purpose schedule of investments to be acquired, which would include only those assets that will be purchased by the registrant. The audited special purpose schedule of investments to be acquired should clearly describe each asset to be acquired, which would include, among other things, disclosure of any noncash interest rate (for example, payment in kind[PIK]). The registrant should also disclose historical and other information about the assets to be acquired from the private fund(s) that would be pertinent to the users of the financial statements, such as the following:

a. Disclosure of any asset that was on partial interest accrual or nonaccrual of interest in any of the last two or three years, as applicable

b. Disclosure of any material changes in the creditworthiness of any borrower in any of the last two or three years, as applicable

c. Disclosure of any restructuring of an asset in the last two or three years, as applicable, such as changes in interest rate, changes in the type of interest (cash to PIK, for example), or changes in the maturity date

d. Narrative disclosure to address the risk of cherry-picking (for example, an adviser causes the BDC or other investment company to purchase nonperforming assets from a private fund), such as a description of why certain assets are being acquired while other assets are not being acquired, as well as a comparison of the performance of acquired assets and the performance of those assets not acquired

e. Either management representation in the registration statement that the fair values of the assets to be acquired have not materially changed since the last audit of each private fund's financial statements, or, if the fair value did materially change, disclosure of the new fair values of the assets

In addition, when BDCs and other registered investment companies are formed by acquiring partial portfolios of private funds or by acquiring entire private funds (either before or after the effectiveness of the initial registration statement), the staff may request the registrant to include in the registration statement seed financial statements, pro forma financial statements, or more recent audited or unaudited financial statements or a special purpose schedule of investments to be acquired. More recent financial information should be considered if, for example

a. investors in the private fund(s) have received more recent audited or unaudited financial information about the private fund(s) that was not filed with the SEC;

b. significant time has passed between the date of the most recent private fund financial statements or special purpose schedule of investments to be acquired;

c. there has been significant turnover in any private fund(s') portfolio since the date of the most recent private fund(s') financial statements or the date of the most recent special purpose schedule of investments to be acquired; or

d. there has been a significant change in the assets (for example, change in fair value of the assets, change in the individual assets selected to be acquired, change in the terms of the assets, and so on) that will be acquired from the private fund(s).

- The SEC staff recently considered nontraded BDC "fee waiver and expense reimbursement plans," under which the adviser waives fees or pays expenses of the BDC to the extent necessary for distributions not to be sourced from return of capital (some plans are designed to prevent a book return of capital, and others are designed to prevent a tax return of capital). These plans typically support a policy of maintaining a high, fixed distribution rate. For example, a BDC with a 9-percent distribution rate target may not have income or earnings and profits sufficient to maintain the 9-percent distribution rate without sourcing part of the distribution from return of capital. In such a situation, the adviser may waive fees or pay the BDC's expenses to the extent necessary for the BDC's income or earnings and profits to equal the amount of the distribution. Typically, these plans provide a mechanism for the adviser to recoup in the future from the BDC the amount of the fees waived or expenses paid on behalf of the BDC. The SEC staff's position is that any recoupment payment must be conditioned on (1) an expense ratio (excluding management or incentive fees) that, after giving effect to the recoupment, is lower than the expense ratio (excluding management or incentive fees) at the time of the fee waiver or expense reimbursement and (2) a distribution level (exclusive of return of capital, if any) equal to, or greater than, the rate at the time of the waiver or reimbursement. Recoupment of fees waived or BDC expenses paid must occur within three years of the date of the waiver or payment. The SEC staff has encouraged registrants to provide clearer explanations of how these plans operate. Finally, the SEC staff has been asking for enhanced disclosure of the terms of the recoupment agreement and a chart explicitly describing the amount of the expenses subject to recoupment, the expense ratio and distribution level at which the adviser can recoup the waived or reimbursed expenses, and the expiration date(s) of the recoupable amount. Disclosure of these types of arrangements should be included in various documents, such as the registration statement, the financial statements, and marketing materials, specifically where references to distribution rates and yields and distributions are made.

- The SEC staff recently considered the calculation and disclosure of an incentive fee for a BDC holding a total return swap (TRS) referenced to an underlying basket of loans. Although Section 15(a)(1) of the 1940 Act states that the advisory contract must precisely describe the fees charged to the BDC, the SEC staff has observed that advisory contracts for certain nontraded BDCs do not precisely describe such fees. These advisory contracts typically do not state much more than the fact that the Adviser's Act formula for calculating the maximum fee based on capital gain would apply to the sale or liquidation of portfolio securities. A TRS is a contractual arrangement with a counterparty intended to provide the BDC with exposure to certain specified reference assets. The SEC staff observed that certain BDCs were calculating capital gain incentive fees on the TRS, with certain specified loans as reference securities based on GAAP requirements for accounting and reporting (for instance, under GAAP, all payments received from the TRS are reported as realized gains and, therefore, BDCs were including all payments received from the TRS in the capital gains incentive fee calculation). Although this is more of a legal, rather than an accounting, interpretation, in response to SEC staff comments, BDCs have indicated they will calculate the incentive fees on TRS based on a "look through" approach as if the BDC held the loans directly. Under this fee calculation method, payments received for interest income earned on the TRS reference loans are included in the income incentive fee calculation (but interest payments received would be reported as realized gains under GAAP), and the TRS reference loan realized gains, realized losses, and unrealized depreciation are included in the capital gain incentive fee calculation.

The SEC staff has indicated that advisory contracts must be amended if they do not precisely describe the incentive fee calculation method or if that method does not apply the look through approach used by the registrant, as described in the previous paragraph. Material amendments to advisory contracts must be submitted to shareholders for approval. Because these amendments are material, the amended contracts require shareholder approval. Registrants that have not used the look through fee calculation method with respect to TRS in the past but are currently using the "look through" method, should calculate past incentive fee amounts using the look through method and reimburse the BDC for any excess fees collected from the BDC.

Presentation and Disclosure of PIK Interest

.48 As defined by the FASB ASC glossary, *PIK bonds* are bonds in which the issuer has the option at each interest payment date of making interest payments in cash or additional debt securities. The SEC staff has provided the following comments related to (*a*) disclosure when a range of PIK interest is allowable under the debt agreement and (*b*) presentation of PIK interest income in the statement of cash flows.

.49 Certain registrants have debt investments that pay both PIK and cash interest. The SEC staff has noticed certain registrants hold debt instruments that have a provision permitting the issuer to determine a range of PIK interest that will be paid, along with a minimum cash percentage to be paid. For example, a bond may have a 15-percent stated interest rate that includes two rate components: (*a*) a minimum cash interest rate of 10 percent and (*b*) a PIK interest rate with a range between 0 percent and 5 percent. The SEC staff believes that if an issuer has the ability to pay a range of PIK interest, the current PIK and cash interest rates should be disclosed on the schedule of investments, along with the possible PIK interest rate range or the maximum PIK interest rate that could be paid. For example, if the issuer of the bond previously referenced with a 15-percent stated interest rate is currently paying 12 percent cash interest and 3 percent PIK interest as of the date of the financial statements, then the schedule of investments would disclose the current 12 percent cash and 3 percent PIK interest rates, along with the range of possible PIK interest rates that could be paid (0–5 percent) or the maximum allowable amount of PIK interest (5 percent).

.50 With respect to the presentation of PIK interest income on the statement of cash flows, the SEC staff's position is that a regulated investment company[2] with a material amount of PIK interest income should separately present the PIK interest income. For example, the regulated investment company could either present PIK interest income as a separate reconciling item within the reconciliation of net increase (decrease) in net assets from operations to net cash provided by (used in) operating activities on the statement of cash flows (that is, not buried in another line item in the statement of cash flows, such as purchases of securities) or disclose the amount of PIK interest income in a footnote to the statement of cash flows.

.51 Registrants are encouraged to consult with the SEC staff when there is a material amount of PIK interest income, and the registrant does not present a statement of cash flows.

[2] Although this position is applicable to all registrants, this comment may be particularly applicable to business development companies (BDCs) because certain BDCs have material amounts of payment-in-kind interest income.

Auditor Consent Requirements

.52 The SEC staff provided its view on whether an independent registered public accounting firm's consent is required in circumstances when (*a*) no financial statements of any kind and (*b*) no "expertization" language referring to the firm are included or incorporated by reference in a registration statement. As an example of such circumstances, the accounting firm is named in Form N-1A, as required by Item 19. In practice, the general counsel of some funds believe that no consent is necessary in those instances, whereas other fund general counsel insist on obtaining consent in any context in which the accounting firm's name appears. Based on Sections 7 and 11 of, and Rule 436 thereunder, the Securities Act of 1933, the SEC staff believes a consent would not be required of the independent public accounting firm when the firm is merely referred to on the forms filed with the SEC in a factual manner similar to any other service provider (for example, pursuant to Item 19(h) of Form N-1A), and no reference is made either to the auditor's report or to the auditor as an "expert."

Reporting Open Repurchase Agreements on Form N-MFP and the Schedule of Investments

.53 *Open repurchase agreements* are agreements under which an investment company purchases securities from a seller who agrees to repurchase them at a specified price, but have no legally specified maturity date and could be called by either party and settled within one business day. The SEC staff recently provided feedback about how to appropriately report open repurchase agreements as part of the portfolio holdings on Form N-MFP, which is required to be filed within five business days after the end of each month, pursuant to Rule 30b1-7. For the purpose of completing Form N-MFP, the maturity date to be included on the form would be "the next business day." The SEC staff believes that the weighted average maturity and weighted average life would be one day for open repurchase agreements, which could be called by either party the next business day. In addition, when open repurchase agreements are disclosed in the schedule of investments in the financial statements, it should be clear the investment may mature within one business day. The SEC staff would not object to an open repurchase agreement being tickmarked in the schedule of investments as "redeemable on demand" or "payable on demand."

Leveling Table Classification for Underlying Funds With Annual and Quarterly Redemptions

.54 The SEC staff has observed that certain registered funds of hedge funds have investments in underlying funds that include redemption restrictions that allow redemption only on an annual basis. These investments sometimes have been classified as level 2 investments in the funds of hedge funds' fair value hierarchies. The SEC staff generally believes an underlying fund investment that can only be redeemed on an annual basis should be classified as level 3 in the fair value hierarchy. However, if an underlying fund investment allows for quarterly redemption, the SEC staff indicated that they generally would not object to classification as level 2 in the fair value hierarchy. The SEC staff's position related to quarterly redemptions is consistent with industry practice, based on the conclusions reached in Technical Question and Answer (TIS) section 2220.25, "Impact of 'Near Term' on Classification Within Fair Value Hierarchy" (AICPA, *Technical Practice Aids*).

Including an Audited Schedule of Investments in Form N-CSR Filings

.55 The SEC staff observed that certain registrants filed financial statements, including a summary schedule of investments in securities of unaffiliated issuers as described in Rule 12-12C of Regulation S-X (summary schedule of investments), but filed the complete schedule of investments in securities of unaffiliated issuers, as described in Rule 12-12 of Regulation S-X, in Form N-CSR (Item 6) excluding the independent auditor's report. As discussed in SEC Release No. IC-26372, the SEC permits a registered investment company to include a summary schedule of investments in its reports to shareholders, provided that the complete schedule of investments is filed with the SEC on Form N-CSR semi-annually and is provided to shareholders upon request, free of charge. The complete schedule of investments that is filed as of year-end on Form N-CSR should be accompanied by an independent auditor's report. Illustrative examples of a separate audit opinion for this purpose can be found in paragraph 11.27 of the investment company guide.

Expense Recoupment Period

.56 FASB ASC 946-20-05-8 explains that some expense limitation agreements may provide that reimbursements by the fund adviser of expenses incurred by the fund in excess of the maximum permitted by the prospectus or offering document will be carried over to a future period and reimbursed to the fund adviser when, and to the extent that, the total expense ratio falls below the permitted maximum. Such agreements may provide that reimbursement of excess expenses to the fund adviser is not required (*a*) after a specified date or (*b*) upon conclusion of a specified period from the time the fund initially incurred (or the adviser initially reimbursed) the expenses, such as three years.

.57 The SEC staff noted that certain recently filed initial registration statements included a description of a recoupment plan period of five years. The SEC staff reminds registrants that, generally, the recoupment plan should have a defined period of three years or less, and if a plan exceeds three years, the fund should accrue for recoupment expenses.

Other Review Findings

.58 The SEC staff has observed the following other review findings:

- The SEC staff has observed certain fund complexes that did not include all the required disclosures about lines of credit, specifically, commitment fees on the unused portion of the line of credit. Rule 6-04.13(b) of Regulation S-X requires registrants to disclose the information required under Rule 5-02.19(b) of Regulation S-X regarding unused lines of credit for short-term financing and Rule 5-02.22(b) of Regulation S-X regarding unused commitments for long-term financing arrangements. Such information should be disclosed, if significant, in the notes to the financial statements and should include the amount and the terms of the unused line of credit, including commitment fees and the conditions under which lines may be withdrawn.
- The SEC staff discussed disclosures when a fund holds a derivative (for example, an option or total return swap) when the underlying is a custom basket of securities or customized index. The question arose regarding whether certain funds are providing adequate disclosure about the underlying holdings in the custom basket or those comprising the customized index. The SEC staff gave an example of a managed futures fund that held a total return swap on a customized basket when the notional value represented approximately 100 percent of the net assets of the fund, and the fund used the total return swap to meet its investment objectives; however, the fund provided no transparency of what securities or other holdings comprise the customized basket. Based on this example, the SEC staff would expect the fund to provide additional transparency about what is included in the custom basket.

Although the SEC staff has observed some funds that lack adequate disclosure, they have also noticed other funds that provide transparency into the holdings in the customized basket. The SEC staff gave an example of a fund that listed each reference security or other holding in the custom basket, including the security or holding name, shares and par value, notional value, unrealized appreciation or depreciation, and other pertinent information. The SEC staff also noted they are reviewing the transparency being provided on fees associated with custom baskets or customized indexes (for example, the total return on the custom basket may be net of certain management and incentive fees).

- The SEC staff has recently observed certain auditor consent letters that are missing the auditor's signature or date. Also, in certain circumstances, the SEC staff has observed that the date of the audit opinion disclosed in the consent letter differs from the actual date of the audit opinion in the fund's audited financial statements (for example, the consent letter references an audit opinion dated February 25, 20X3, but the audit opinion in the financial statements was actually dated February 26, 20X3).
- The SEC staff recently considered a specific fact pattern in which a registrant created a new legal entity (a "shell" fund with no operations), and that shell fund acquired assets and liabilities from a third-party registered investment company (RIC), and that acquired RIC then became the accounting survivor (the shell fund is the legal survivor). In this situation, the shell fund has a different auditor than the RIC accounting survivor, and the SEC staff would expect the required change in auditor notifications and disclosures to be made in accordance with Item 77K of Form N-SAR (Item 77K of Form N-SAR refers registrants to certain information required by Item 4 of Form 8-K, which, in turn, refers to certain requirements in Item 304 of Regulation S-K).
- The SEC staff has observed certain BDCs, and funds of funds, that do not include required disclosures in connection with Rule 12-14 "Investments in and Advances to Affiliates" of Regulation S-X in their financial statements. This rule requires registrants to disclose certain financial information about affiliated investments.

Custody Rule Observations

.59 The SEC staff provided clarifying views on when the Custody Rule requirements must be satisfied, given the following scenarios:

- *Custody Rule application during fund start-up phase.* A registered investment adviser (RIA) launches a private fund, which is an advisory client. In November 2012, the private fund accepted capital commitments from investors. The fund did not call capital from investors until January 2013, did not make any investments on behalf of investors during 2012, and there was no cash activity in 2012. The SEC staff commented that based on this fact pattern, the adviser would not need to satisfy Custody Rule requirements for 2012 for that fund. If the previous scenario was modified whereby the RIA called capital and received the cash but did not use the proceeds to buy any securities during 2012, the SEC staff indicated that the adviser would be deemed to have custody of client assets and would need to satisfy the Custody Rule for 2012, even though there is no trading activity during the year. The rationale is that the RIA, after receiving the cash proceeds from the capital call, is holding client funds for purposes of the Custody Rule.
- *Custody Rule application during fund liquidation.* An RIA managed a private fund from January 1 through November 30, 2012. The fund liquidated as of November 30, 2012. The adviser did not manage any other private funds, and the adviser deregistered from the SEC on December 15, 2012. The SEC staff indicated that the RIA would need to comply with the Custody Rule for 2012, which may include a liquidation audit.

- *Custody Rule application during fund wind-down phase.* An RIA manages a private fund with a December 31 year-end that has been winding down operations. No securities were held by the fund during 2012 or January 2013; the only assets held during this time were cash and an escrow receivable. The fund continued operations through 2012 and early 2013 solely to pay the final cash distribution to the partners. Further details of the fund are as follows:

  — XX Partners LP: During 2008, XX sold its last security, and $10,000 was recorded as an escrow receivable. As of December 31, 2012, XX held $12,000 in cash, of which the majority was related to the receipt of the escrow during 2012. The final distribution to partners occurred in January 2013.

The SEC staff was specifically asked about Custody Rule compliance for 2012 and 2013. The SEC staff indicated the RIA is required to satisfy the Custody Rule for 2012 and 2013. In order to use the audit provision to satisfy the Custody Rule, an audit shall occur once every 12 months; therefore, an audit would be needed for the year ended December 31, 2012 (covering January 1, 2012 to December 31, 2012) and for the 2013 stub period. The RIA could either (*a*) distribute 2 separate sets of audited financial statements to investors within 120 days of December 31, 2012 (one set for the 12 month fiscal year ended December 31, 2012 and one set for the 2013 stub period) or (*2*) distribute 1 set of audited financial statements if they are distributed to investors within 120 days of December 31, 2012, as long as the financial statements included 2 audited balance sheets (as of December 31, 2012 and as of the end of the 2013 stub period) and 2 audited income statements, 2 audited statements of cash flows (if required), and 2 audited statements of changes in net assets for the period from January 1, 2012 to December 31, 2012 and for the 2013 stub period. The SEC staff encouraged registrants to consult with SEC staff about particular fact patterns.

.60 The SEC staff provided the following additional Custody Rule observations:

- The Division of Investment Management released Investment Management Guidance Update No. 2013-04 in August 2013 to provide guidance pertaining to privately offered securities under the Custody Rule in response to inquiries received from advisers to pooled investment vehicles. These advisers inquired whether they have to maintain with a qualified custodian certain instruments evidencing a pool's ownership of certain privately issued securities (namely, nontransferable stock certificates or "certificated" limited liability companies interests) that were obtained in a private placement (private stock certificates). The focus of these inquiries commonly involves whether these securities meet the Custody Rule's definition of privately offered security and, therefore, would not have to be held at a qualified custodian. Among other things, advisers contended that (*a*) such securities are similar, in all material respects, to a privately offered security; (*b*) the audit of a pooled investment vehicle's financial statements provide substantial investor protection; and (*c*) maintaining private stock certificates at a qualified custodian does not provide meaningful additional protection to investors.

- Within the guidance update, the Division of Investment Management explained they would not object if an adviser does not maintain private stock certificates with a qualified custodian, provided that (*a*) the client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the Custody Rule; (*b*) the private stock certificate can only be used to effect a transfer or otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer; (*c*) ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client; (*d*) the private stock certificate contains a legend restricting transfer; and (*e*) the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

- Readers can access the full text of this guidance update on the Division of Investment Management website at www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

- Certain Custody Rule transitional guidance discussed in Section I, "Compliance Dates," of the SEC staff's Custody Rule FAQs is no longer applicable to RIAs. The transitional guidance in Section 1 was only applicable to RIAs that were subject to the Custody Rule at the effective date (March 12, 2010) and are not applicable to those RIAs that became subject to the Custody Rule subsequent to its effective date. The SEC staff's Custody Rule FAQs can be accessed in full on the SEC's webpage at www.sec.gov/divisions/investment/custody_faq_030510.htm.

- On March 4, 2013, the SEC's National Exam Program staff issued a Risk Alert on observations regarding ways in which advisers fail to comply with the Custody Rule. Also in March 2013, the SEC's Office of Investor Education and Advocacy issued an Investor Bulletin about the custody of investment assets, which describes to investors what custody is and also what the Custody Rule means to investors as well as what it requires. The Risk Alert highlights significant compliance deficiencies noted during recent examinations conducted by the Office of Compliance Inspections and Examinations (OCIE). The examinations identified custody-related issues in about one-third of the firms examined. The RIAs' deficiencies included the following:

- Failure by the RIA to recognize that they have custody, such as situations in which
  - the RIA's personnel or a "related person" serves as trustee or have been granted power of attorney for client accounts
  - the RIA provides bill-paying services for clients and, therefore, is authorized to withdraw funds or securities from the client's account
  - the RIA manages portfolios by directly accessing online accounts using clients' personal usernames and passwords without restrictions and, therefore, has the ability to withdraw funds and securities from the clients' accounts
  - the RIA serves as the general partner of a limited partnership or holds a comparable position for a different type of pooled investment vehicle
  - the RIA has physical possession of client assets, such as securities certificates
  - the RIA or a related person has signatory and check writing authority for client accounts
  - the RIA received checks made out to clients and failed to return them promptly to the sender
- Failure to meet the Custody Rule's surprise examination requirements, including failure to file Form ADV-E within 120 days after the date of the exam chosen by the accountant and evidence suggesting that examinations were not being conducted on a "surprise" basis (for example, exams were conducted at the same time each year).

— Failure to satisfy the Custody Rule's qualified custodian requirements, such as the following:

  - Client assets were held in the RIA's name but not in an account that was under the RIA's name as agent or trustee for the client and that held only client assets.

  - The RIA commingled client, proprietary, and employee assets into one account.

  - Certificates of securities held by the RIA's fund were held in a safe deposit box controlled by the adviser at a local bank.

  - The RIA did not have a reasonable basis, after due inquiry, for believing that a qualified custodian was sending quarterly account statements to the client.

  - In instances in which the RIA opened a custodial account on behalf of a client and sent account statements to the client, the statements sent by the RIA failed to include notification urging clients to compare the account statements from the custodian with those from the RIA.

— Failure to meet the Custody Rule's "Audit Approach" requirements with respect to pooled investment vehicles because

  - the accountant that conducted the financial statement audit was not "independent" under Regulation S-X, as required by the Custody Rule.

  - the audited financial statements were not prepared in accordance with U.S. GAAP (for example, organizational expenses were improperly amortized, rather than expensed as incurred, resulting in a qualified audit opinion; financial statements were prepared on a federal income tax basis; the RIA could not substantiate fair valuations, and the accountant, therefore, could not issue an unqualified opinion on the financial statements).

- the RIA failed to demonstrate that the audited financial statements were distributed to *all* fund investors; rather, it appeared that in many instances the statements were only made available “upon request.”

- the audited financial statements were not sent to investors within 120 days of the private funds’ fiscal year ends (or 180 days for funds of funds).

- the auditor was not registered with the Public Company Accounting Oversight Board (PCAOB) and not subject to regular PCAOB inspection.

- a final audit was not performed on liquidated pooled investment vehicles

- the adviser requested investor approval to waive the annual financial audit of a fund—but did not obtain a surprise examination. The adviser, therefore, failed to either undergo a surprise exam or comply with the audit approach.

.61 The SEC staff provided the following additional Custody Rule observations associated with recent OCIE findings:

- To use the “audit provision” allowed under 206(4)-2(b)(4) of the Custody Rule, the audit must meet the requirements of GAAS. For further discussion, see Custody Rule FAQ item VI.6 at http://sec.gov/divisions/investment/custody_faq_030510.htm.

- For pooled investment vehicles (PIVs), the financial statements of the PIV generally must be prepared in accordance with U.S. GAAP. However, PIVs organized outside the United States, or having a general partner or other manager with a principal place of business outside the United States, may have their financial statements prepared in accordance with accounting standards other than U.S. GAAP, as long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP. Any material differences from U.S. GAAP must be reconciled. The SEC staff has observed certain offshore funds that intended to use International Financial Reporting Standards (IFRSs) financial statements to satisfy the Custody Rule but did not include an audited condensed schedule of investments or audited financial highlights, which the SEC staff believes should be included to satisfy the Custody Rule. See Custody Rule FAQ item VI.5 for further discussion, available at http://sec.gov/divisions/investment/custody_faq_030510.htm.

- The SEC staff observed the following themes during reviews of the accountants' notifications of material discrepancies pursuant to Rule 206(4)-2(a)(4)(ii) related to RIAs' compliance with the Custody Rule:

  — The RIA did not engage an independent public accountant to perform an annual surprise examination in the prior year in accordance with Rule 206(4)-2(a)(4) because the RIA was not aware of such requirement.

  — There was no notification within the RIA's quarterly account statements sent to the RIA's clients urging them to compare quarterly account statements received from the qualified custodian to the quarterly account statements received from the RIA, as required by Rule 206(4)-2(a)(2).

  — The RIA did not have a reasonable basis, after due inquiry, for believing that the qualified custodian was sending account statements to each client for which the RIA maintains funds or securities, on at least a quarterly basis, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during the period, as required by Rule 206(4)-2(a)(3).

  — The RIA sponsored a PIV for which audited financial statements were not prepared in accordance with GAAP. Because the RIA could not rely on the audit provision under Rule 206(4)-2(b)(4), a qualified custodian was required to send quarterly account statements to each pool investor pursuant to Rule 206(4)-2(a)(5) and hold privately offered securities pursuant to Rule 206(4)-2(b)(2)(ii). However, quarterly account statements were not sent to pool investors by the qualified custodian, and the RIA failed to have the privately offered securities held by a qualified custodian.

Considerations Pertaining to Fair Value Methods, Procedures, and Internal Controls for Investment Portfolio Securities

Internal Controls Pertaining to Third-Party Pricing Services

.62 Brian Croteau, Deputy Chief Accountant in the SEC's Office of the Chief Accountant, provided remarks at the 2012 AICPA Conference on Current SEC and PCAOB Developments regarding management's use of, and responsibility for, valuations performed by third-party pricing services. Mr. Croteau indicated that although there are reasons to be encouraged by the progress, this is still an area where attention is necessary. For example, Mr. Croteau reminded registrants of the importance of developing and maintaining internal controls to provide management with the basis to take responsibility for the financial statements. One area in particular that may warrant increased focus is ensuring that adequate controls are in place and operating effectively to identify when securities begin to become thinly traded, so that necessary changes to the valuation approach and related measurements and disclosures would be made on a timely basis. The full text of this speech is available at www.sec.gov/news/speech/2012/spch120312btc.htm.

Validation of Cost or Par Versus Determining a Point in the Range That Is Most Representative of Fair Value

.63 The SEC staff has observed that certain registrants are using a "market yield" valuation methodology when valuing their debt investments in noncontrolled companies. This methodology includes developing a range of market yields and comparing the contractual interest rate of the security to the range of market yields. When looking at the values estimated under this approach during recent financial statement reviews of certain registrants, the SEC staff noted that the values consistently reflected cost or par. The SEC staff was concerned that the registrants' methodologies appeared to focus on validating cost or par, rather than determining the point within the range most representative of fair value. The SEC staff reminded management of its responsibility to ensure that its methodology, and resulting estimates, are consistent with FASB ASC 820 and, more specifically, FASB ASC 820-10-35-54(f), which indicates, among other things, that "[t]he objective is to determine the point within the range that is *most* representative of fair value under current market conditions. A wide range of fair value measurements may be an indication that further analysis is needed." (Emphasis added.)

Recent Litigation Proceedings Pertaining to Fair Value Methods, Procedures, and Internal Controls for Investment Portfolio Securities

.64 The SEC staff reminds registrants and auditors that the following cases are examples of the current focus on fair value accounting throughout the SEC.

KCAP Financial, Inc.

.65 In November 2012, the SEC Division of Enforcement issued an order instituting cease and desist proceedings against KCAP Financial, Inc. (the order), a BDC that primarily held debt securities and CLOs, and several members of KCAP's management. The order explains that KCAP materially overstated the value of its investment portfolio, which resulted in an overstated net asset value (NAV) of approximately 27 percent and a restatement of its financial statements.

.66 KCAP utilized the following fair value methodologies and policies that were not in accordance with GAAP or applicable regulations:

- KCAP used an enterprise value methodology to determine fair value for certain noncontrolled debt holdings, which resulted in many securities being valued at par. The enterprise valuation methodology for debt holdings of noncontrolled companies did not take into account market-based activity and did not reflect an exit price in accordance with GAAP.

- KCAP ignored quotes from third-party pricing services and concluded all trades of debt securities owned by KCAP reflected distressed transactions. This approach did not consider relevant guidance in FASB Staff Position No. 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" (codified in FASB ASC 820-10-35), which explains that even in times of market dislocation, it is not appropriate to conclude that all market activity represents distressed sales or forced liquidations.

- KCAP valued two of its largest CLOs at historical cost, which did not consider certain market-based activity. Furthermore, the CLO valuation methodologies disclosed in KCAP's public filings were materially misleading because they noted the use of a discounted cash flow method that incorporated current market data, although in reality, they did not, because two of the largest CLOs were valued at cost.

.67 The full text of the order can be found at www.sec.gov/litigation/admin/2012/34-68307.pdf.

Yorkville Advisors, LLC

.68 In October 2012, the SEC filed a complaint against Yorkville Advisors, LLC and two of its executives. Yorkville Advisors manages a number of hedge funds that invest in convertible debentures, convertible preferred stock, and promissory notes. The SEC's allegations included that Yorkville Advisors and two of its executives did not adhere to its stated valuation policies, ignored negative information about certain investments, and withheld that information from the auditors, which enabled Yorkville Advisors to carry some of its largest investments at inflated values and, in turn, resulted in inflated fund NAVs. Yorkville Advisors allegedly increased the reported value of fund assets to increase assets under management, claim higher management and incentive fees, and maintain positive year end performance. For more information, visit www.sec.gov/litigation/complaints/2012/comp-pr2012-209.pdf.

Morgan Keegan and Company, Inc.—Fund Directors

.69 In December 2012, the SEC Division of Enforcement brought an allegation against eight former members of the board of directors (the directors) of five registered investment companies advised by Morgan Keegan & Company, Inc. (the funds), alleging that the directors caused the funds to violate federal securities laws by failing to adopt and implement meaningful fair valuation methodologies and procedures and maintain internal control over financial reporting. For example, the SEC alleged that the funds' valuation procedures did not include any mechanism for identifying and reviewing fair-valued securities whose prices remained unchanged for weeks, months, and even entire quarters. The full text of the proceeding is available at www.sec.gov/litigation/admin/2012/ic-30300.pdf.

.70 In June 2013, the directors settled with the SEC. The settled order, as summarized in the SEC's June 13, 2013 press release, provides additional details about how the directors failed to satisfy their pricing responsibilities under federal securities laws. The settled order finds that the directors caused the funds' violation of Rule 38a-1 under the 1940 Act, which requires funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. The directors are also ordered to cease and desist from committing or causing any current and future violations of that rule. The directors consented to the entry of the settled order without admitting or denying any of the findings, except about jurisdiction.

Change to the SEC's Position on ETF Exemptive Requests

.71 In March 2010, the SEC announced, through a press release, that the staff was conducting a review to evaluate the use of derivatives by mutual funds, ETFs, and other investment companies. The press release also indicated that, pending completion of the review, the staff would defer consideration of exemptive requests under the 1940 Act relating to actively- managed and leveraged ETFs that would make significant investments in derivatives.

.72 On August 31, 2011, as a continuation of the ongoing review, the SEC approved the issuance of a Concept Release under the 1940 Act relating to derivatives. When the 1940 Act was enacted, it did not contemplate funds investing in derivatives, as they do today. The use and complexity of derivatives have grown significantly over the past two decades and have given rise to many interpretive and policy issues under the 1940 Act. As a result, the SEC determined to solicit public comment (through the Concept Release) on the current regulatory regime under the 1940 Act as it applies to funds' use of derivatives and on potential improvements to that framework. The Concept Release asked for information on how different types of funds use various types of derivatives, as well as the benefits, risks, and costs of using derivatives, among other things. It also asked for comment on several specific issues under the 1940 Act implicated by funds' use of derivatives, such as how to measure the amount of leverage that a fund incurs when it invests in a derivative, how a fund should value derivatives for diversification purposes, and how funds determine the industry or industries to which they may be exposed through a derivative investment.

.73 A variety of responses were received. The SEC staff continues to actively analyze issues raised by commenters, follows up with certain commenters on issues or suggestions raised, and is formulating initial recommendations for potential further guidance.

.74 On December 6, 2012, during a speech at the American Law Institute Continuing Legal Education 2012 Conference on Investment Adviser Regulation, Norm Champ stated although the Division of Investment Management continues its ongoing review of the use of derivatives by funds, the SEC staff will no longer defer consideration of exemptive requests under the 1940 Act relating to actively-managed ETFs that make use of derivatives, provided any such exemptive request includes two specific representations to address some of the concerns that led to the SEC staff's decision to defer consideration of these types of applications. Mr. Champ explained that to receive the exemptive relief, the exemptive request must include the following two specific representations:

- The ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives.
- The ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant SEC and staff guidance.

.75 The SEC still does not support new exemptive relief for leveraged ETFs because of additional concerns. The full text of this speech is available at www.sec.gov/news/speech/2012/spch120612nc.htm. SEC staff guidance pertaining to derivatives disclosures is available on the SEC's website, including the Division of Investment Management staff's Topical Reference Guide page.

Issues of Interest—Form N-1A Calculation of After-Tax Return

.76 The Division of Investment Management staff occasionally identifies issues under the 1940 Act, the Advisers Act, or other federal securities laws that may benefit from being highlighted generally for investment companies, investment advisers, and their counsel. These issue summaries and related SEC staff responses are designated as issues of interest or Investment Management guidance updates (beginning in March 2013). A recent issue of interest is summarized in the subsequent paragraph. Readers may access the complete listing of issues of interest from the Division of Investment Management page at www.sec.gov. Issues of interest and guidance updates maintained on the web page are not intended as a comprehensive summary of all legal and compliance matters pertaining to the topics discussed therein. Rather, the SEC staff's responses are intended as general guidance and should not be relied on as definitive. The summaries are not rules, regulations, or statements of the SEC, and the SEC has neither approved nor disapproved these summaries.

.77 Effective January 1, 2013, the Health Care and Education Reconciliation Act of 2010 imposed on certain taxpayers a 3.8 percent tax on net investment income (3.8 percent tax). Practitioners raised questions about whether the 3.8 percent tax should be included when determining the highest individual marginal federal income tax rate (which is used to calculate after-tax return, as required by Instruction 4 to both Item 26(b)(2) and (3) of Form N-1A). The SEC staff explained that because investors that are subject to the highest marginal rate on taxable income (currently 39.6 percent) are also subject to the 3.8 percent tax, registrants should include the 3.8 percent tax in after-tax return calculations (for example, use 43.4 percent as the highest individual marginal federal income tax rate on ordinary income). Similarly, the 3.8 percent tax should be included when calculating the tax on qualified dividend income and long-term capital gains or any tax benefit resulting from capital losses required by Instruction 7 to Item 26(b)(3) (in other words, use 23.8 percent as the highest individual federal long-term capital gains tax rate, which is the sum of the 3.8 percent tax and the 20 percent maximum long-term capital gains tax rate). For the full text of the guidance, please refer to www.sec.gov/divisions/investment/issues-of-interest.shtml#after-tax.

Copley Fund, Inc. No-Action Request and SEC Staff Denial

.78 The SEC staff recently issued a letter denying the no-action relief requested by Copley Fund, Inc. (Copley), an open-end fund and a C corporation for tax purposes (a tax paying entity and not a regulated investment company under Subchapter M of the Internal Revenue Code). Copley sought relief from recording the full amount of its deferred federal tax liability on unrealized gains, which is required to be recorded by tax-paying entities pursuant to FASB ASC 740, Income Taxes. Instead, Copley proposed calculating its deferred federal tax liability for unrealized gains based on a management-developed estimate that is a pre-set formula. In its response, the SEC staff declined to provide assurance that it would not recommend enforcement action to the SEC against Copley under Rule 22c-1 under the 1940 Act and Rule 4-01(a)(1) of Regulation S-X if Copley calculated its deferred tax liability as Copley proposed. For more information, the no-action request and SEC staff denial can be accessed on the SEC's website at www.sec.gov/divisions/investment/noaction/2013/copley-fund-040513-22c1.pdf.

Average Annual Return Information—Form N-1A and XBRL Considerations

.79 Regarding Form N-1A and XBRL, the SEC staff has received questions related to average annual return information, which is required in Item 4 of Form N-1A for 1, 5, and 10 years. The questions relate to how the 3-year average annual return and how a column for a secondary inception date should be tagged using the elements within the XBRL taxonomy. Through discussions with registrants, the SEC staff identified some registrants that may be using a draft taxonomy document that was posted to the SEC's website for a brief period of time, but has since been removed, as a guide to what may be included in Form N-1A. The draft document erroneously included references to both the 3-year average annual return and a column for a secondary inception date (both of which are not permitted under Form N-1A). The SEC staff reminded registrants to carefully review the Form N-1A instructions for the requirements of what should be included in Form N-1A. The SEC staff also reminded registrants that the best document to use for XBRL filings is the Mutual Fund Risk/Return Summary Taxonomy Preparers Guide specific for mutual funds, which can be accessed at http://xbrl.sec.gov/rr/2012/rr-preparers-guide-2012-03-26.pdf.

Financial Reporting and Auditing Task Force

.80 The SEC Division of Enforcement has created the Financial Reporting and Auditing Task Force (the task force) as they renew their focus on accounting fraud. Andrew Ceresney, Co-Director of the Division of Enforcement, described the purpose and role of the task force during a speech at the American Law Institute Continuing Legal Education Conference on September 19, 2013. As explained by Mr. Ceresney, the task force has about 12 staff members, made up of both lawyers and accountants. Its objective is to improve the Division of Enforcement's ability to detect and prevent financial statement and other accounting fraud. It will be devoted to developing state-of-the-art methodologies that better uncover accounting fraud and incubating cases that will then be handled by other groups within the Division of Enforcement.

.81 To fulfill its mandate and find promising investigations, the task force plans to launch various initiatives, which may include closely monitoring high-risk companies to identify potential misconduct, analyzing performance trends by industry, reviewing class action and other filings related to alleged fraudulent financial reporting, tapping into academic work on accounting and auditing fraud, and conducting street sweeps in particular industries and accounting areas. The task force will also utilize recently developed technologies, such as the Division of Enforcement's Accounting Quality Model and related tools, which uses data analytics to assess the degree to which a company's financial statements appear anomalous.

.82 Mr. Ceresney explained that the task force will continue to cover a wide variety of issues but also described some examples of specific areas of focus. These examples are described in detail within the speech, which readers can access and review in detail at www.sec.gov/News/Speech/Detail/Speech/1370539845772#.UIw6cdLktgg.

2013 OCIE Examination Priorities

.83 The SEC's OCIE announced the National Examination Program's (NEP's) 2013 examination priorities for investment advisers and investment companies, broker-dealers, clearing and transfer agents, and market oversight. The NEP's priorities include focus areas specific to the investment adviser-investment company exam program, which are divided into

- *ongoing risks,* which will include safety of assets, conflicts of interest related to compensation arrangements, marketing and performance, conflicts of interest related to allocation of investment opportunities, and fund governance.
- *new and emerging risks,* which will include new registrants, dually registered investment advisers and broker-dealers, "alternative" investment companies, and payments for distributions in guise.
- *policy topics,* which will include money market funds, compliance with exemptive orders, and compliance with the pay-to-play rule.

.84 For full text, please visit www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

OCIE Focus Areas in 2013

.85 The OCIE has identified and communicated focus areas that represent areas of concern. These focus areas include, but are not limited to the following:

- *Alternative and hedge fund investment strategies in open-end funds, ETFs, and variable annuity structures*. The focus is on assessing whether

    - leverage, liquidity, and valuation policies and practices comply with regulations;

    - boards, compliance personnel, and back offices are staffed, funded, and empowered to handle the new strategies; and,

    - the funds are being marketed to investors in compliance with regulations.

- *Conflicts of interest related to the allocation of investment opportunities*. The specific focus is on the appropriate controls being in place to monitor the side-by-side management of performance-based fee accounts with nonincentive fee-based accounts with similar investment objectives. Advisers managing accounts that do not pay performance-based fees (for example, most mutual funds) side-by-side with accounts that do pay performance-based fees (for example, most hedge funds) face unique conflicts of interest.

- *Payments for distributions in guise*. The focus is on the wide variety of payments made by advisers and funds to distributors and intermediaries. This focus area also includes the adequacy of disclosure made to fund boards about these payments, as well as the board's oversight of the same. These payments go by many names and are purportedly made for a variety of services, most commonly revenue sharing, subtransfer agent, shareholder servicing, and conference support. OCIE will assess whether such payments are made in compliance with regulations (for example, Rule 12b-1) or whether such payments are, instead, payments for distribution and preferential treatment.

- *Money market funds*. The focus is on stress testing of money market funds, including

    - whether firms are conducting stress testing,

    - what factors firms are considering when stress testing, and

    - the results of the stress testing.

    - Rule 2a-7 of the 1940 Act requires money market funds to periodically stress test their ability to maintain a stable share price based on hypothetical events, including changes in short-term interest rates, increased redemptions, downgrades and defaults, and changes in spreads from selected benchmarks.

- *Compliance with exemptive orders*. When applicable, the OCIE will focus on compliance with previously granted exemptive orders, such as those related to
  - closed-end funds and managed distribution plans,
  - employee securities companies,
  - ETFs and the use of custom baskets, and
  - those granted to fund advisers and their affiliates permitting them to engage in coinvestment opportunities with the funds.

  Practitioners should refer to the Investment Management Guidance Update No. 2013-02, released in May 2013 and available on the Division of Investment Management website, which explains how entities receiving and relying upon exemptive orders can address the risk of violating the federal securities laws caused by noncompliance with the representations and conditions of such orders.

.86 For further discussion of these and other examination priorities, please visit www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.