Investment Companies Expert Panel

Highlights of the January 16, 2018 Meeting

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the meeting:

I. AICPA/Administrative:

1. The EP chair thanked outgoing members for their contributions to the AICPA EP and CPA profession over the past three years.

2. The Expert Panel (EP) May and September meetings and July and November 2017 calls highlights are being finalized.

3. The AICPA staff updated the EP on recent developments regarding the AICPA Asset Management Revenue Recognition Task force.

4. The AICPA staff and the EP members considered various AICPA Audit and Accounting Guide *Investment Companies* (the Guide) matters. In particular,

    a. The EP considered whether the auditor’s report on internal control required by SEC under Form N-SAR should be updated to conform to the new reporting provisions prescribed by PCAOB Release No. 2017-001 (AS 3101, AS 3105, AS 1220, AS 1301, AS 2201, AS 2820, & AS 4105). The EP currently expressed a view that the report should not be updated but will continue to discuss as the EP members discuss within their firms.

       The EP also noted that Form N-SAR will be rescinded effective June 1, 2018, once Form N-CEN is effective.

    b. The EP also discussed potential enhancive update to the Guide on cryptocurrency. The EP will monitor AICPA developments on this topic and will revisit this topic during future EP calls.

II. Accounting/Reporting Issues:

1. The EP members discussed accounting methods for various loan fees that are received by BDCs or other types of funds with lending activities. Examples of types of loan fees received by BDCs include origination and upfront structuring fees, syndication fees, commitment fees, amendment or

restructuring fees and prepayment fees. An EP member inquired whether BDCs are adopting the new revenue recognition guidance in ASC 606, *Revenue from Contracts with Customers*, for these fees or applying FASB ASC 310-20 (formerly known as FAS 91) or other guidance. The EP members acknowledged certain diversity in practice in historic accounting for loan origination fees, yet, noted that certain BDCs and investment companies have been and are currently following guidance in FASB ASC 310-20, *Nonrefundable Fees and Other Costs*, and not necessarily revenue recognition guidance, if the activities are covered within FASB ASC 310-20. These entities have historically applied ASC 310-20 by analogy because ASC 946 is silent on the accounting for loan origination fees. The EP members discussed that financial instruments and other contractual rights or obligations within the scope of ASC 310 are specifically scoped out of ASC 606.

The EP will continue discussing this topic at the March EP conference call.

2. The Chicago Mercantile Exchange (CME) and LCH.Clearnet Limited (LCH) have amended their rulebooks to legally characterize variation margin payments for over-the-counter (OTC) derivatives they clear as settlements rather than collateral ("settled to market"). Some clearing members do not report the variation margin payments for each individual derivative contract, but on an aggregate basis. The EP discussed how nonregistered investment companies should present centrally cleared derivatives on the balance sheet and how the FASB ASC 820 fair value hierarchy disclosures required by ASC 820-10-50-2(a) and (b) may be affected. Additionally, the EP considered the effect, if any, on the ASC 815 derivative disclosures outlined by ASC 815-10-50-4A(a) and ASC 815-10-50-4B(c), which require derivative instruments to be presented as separate asset and liability values, segregated by type of contract (e.g. interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, etc.).

An EP member shared that historically, nonregistered investment companies presented the fair value of centrally cleared derivatives as a separate unit of account on the balance sheet, separate from the related variation margin payments. The variation margin payments have historically been presented as collateral on the balance sheet (i.e., balance sheet has been presented gross). However, due to the changes in the CME and LCH rulebooks, variation margin payments will be treated as legal settlement of open contracts between the clearing house and the clearing member. Investment companies should treat the fair value and related variation margin payments as a single unit of account and present the amounts net on the balance sheet when there is legal settlement between the fund and the clearing member, which is a legal determination that should be made by the fund.

With respect to the disclosures required under ASC 820 and ASC 815, the EP generally agreed that investment companies may analogize to the guidance in ASC 946-210-50-6(e) for futures contracts, consistent with the schedule of investments disclosures discussed in the November 2017 meeting, and show the cumulative appreciation/depreciation for open centrally cleared derivative contracts. One EP member acknowledged that for purposes of FASB ASC 820 and FASB ASC 815 disclosures, derivative assets and liabilities included in these disclosures are presented at fair value, as shown on the balance sheet, which under legal settlement would be zero or close to zero. For example, if a fund holds centrally cleared swaps with a gross unrealized depreciation of $675,000 and the fund has made margin payments to the counterparty in the same amount, the fair value of the centrally cleared swaps would be $0 on the balance sheet, as the swaps and related variation margin payment are viewed as a single unit of account. For the ASC 820 fair value hierarchy, the fund may elect to disclose the fair value of these centrally cleared swaps as an other financial instruments liability of $675,000 (i.e., gross fair value) or disclose the fair value as $0 (i.e. net presentation). For the ASC 815 asset/liability fair value disclosures, the fund may elect to disclose the gross value of the liability derivative (i.e. $675,000) or the net value which is presented on the balance sheet (i.e. $0). The EP members did not object to either presentation for ASC 820 or ASC 815 disclosures. One EP member noted it would be appropriate to consider materiality and also perform a qualitative and quantitative assessment.

3. The FASB issued ASU 2017-01, *Clarifying the Definition of a Business*, which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business. Given the amendments to ASC 805, *Business Combinations,* the EP considered whether fund mergers would be considered business combinations or rather asset acquisitions and whether revisions to TQA 6910.33, "Certain

Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination" are needed.

An EP member questioned if the acquisition of advisory contracts may support an argument that a business was acquired, as the advisory contracts may give the acquiring entity rights to processes and inputs. However, some EP members believe that the advisory contracts do not survive when funds merge, as new contracts are issued which might suggest a business was not acquired.

The EP will continue discussing this topic at the March EP conference call.

4. The FASB issued final guidance in ASU 2016-18, *Restricted Cash*, to clarify how entities should present restricted cash and restricted cash equivalents in the statement of cash flows. For public business entities, the ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted.

The ASU requires entities to show the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows; however, the ASU does not define restricted cash.

Given this new guidance, the EP discussed how investment companies determine whether certain amounts included in "due from broker" or "deposits for derivatives/securities sold short" are considered restricted cash and should be reflected as restricted cash on the statement of cash flows upon adoption of the ASU. The EP members noted the importance of understanding legal arrangements to determine whether broker balances or deposits are considered restricted cash.

III. Audit and Attest Issues

1. Custody Rule:

a. The EP discussed the independent public accountant's responsibility under the attestation standards to test the completeness of the population of client accounts over which the RIA is considered to have custody when performing an independent verification of client funds and securities pursuant to Rule 206(4)-2(a)(4). Certain EP members expressed a view that testing completeness of the population of client accounts is a legal determination, rather than a requirement under the attestation standards, as clients typically instruct accountants as to which accounts are subject to the custody rule.

The EP will continue discussing this topic at the March EP conference call.

b. The EP also considered the independent public accountant's responsibility under the attestation standards with regard to previously issued surprise examination reports when an RIA is unable to comply with the SEC's no-action letter (NAL) on the use of standing letters of authorization. The NAL states that the SEC believes an adviser has custody of a client's assets if it has the power to dispose of the client's funds or securities for any purpose other than authorized trading. The NAL also states that a letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian constitutes an arrangement under which an investment adviser has custody. The NAL provided detailed actions the adviser must take to comply with the relief. The EP members noted compliance with the custody rule is a legal determination.

The EP will continue discussing this topic at the March EP conference call.

IV. SEC Staff Update

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 comments and observations 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.

1. Agency Rule list:

The Fall 2017 SEC agency rule list includes, among others, forthcoming rules on ETFs, enhanced disclosure for separate accounts registered as UITs and offering variable annuities, auditor independence with respect to loans or debtor-creditor relationships, and investment company reporting modernization – option for website transmission of shareholder reports.

2. Initiatives in Investment Management (Investor Experience, Board Outreach, Valuation Guidance, and Cryptocurrency):

In her speech at the ICI Securities Law Developments Council on December 7, 2017, Dalia Blass, Director for the Division of Investment Management, highlighted the investor experience and board outreach as two current initiatives of the Division. Additionally, she commented that the Division of Investment Management anticipates working with the SEC's Office of the Chief Accountant to look at valuation. Specifically, they would focus on identifying recommendations for updates to staff guidance on valuation of securities and other assets held by registered investment companies.

She also mentioned cryptocurrency as a new innovation in the asset management space and noted several recent filings for registered funds that would hold cryptocurrency. Dalia Blass noted several concerns regarding these new types of products, including whether retail investors would have sufficient information about these products and fully understand their risks, how these funds would fit into existing regulatory framework, and which regulatory structures apply to the market for the underlying instrument.

The SEC staff shared relevant SEC staff speeches and publications on cryptocurrency or related virtual assets:

- SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017)
- SEC Division of Enforcement and SEC Office of Compliance Inspections and Examinations Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others (Nov. 1, 2017)
- Investor Alert: Public Companies Making ICO-Related Claims (Aug. 28, 2017)
- Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017)
- Investor Bulletin: Initial Coin Offerings (July 25, 2017)
- Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014)
- Investor Alert: Ponzi Schemes Using Virtual Currencies (July 23, 2013)

The staff highlighted that a legal and accounting framework exists and applies and that a holder, including an investment company, will need to consider the appropriate guidance based on the nature of its holdings. They discussed that there have been several registrants that want to invest in virtual assets and have attempted to register their products with the SEC. The staff discussed various concerns with virtual assets, including valuation (whether a fund's Board would have adequate information on daily basis to value the token, lack of depth in trading markets and volatile markets), custody (whether a fund that invests directly into virtual assets would be able to verify existence, including exclusive ownership, and concerns about software functionality) and price volatility for these investments. In light of these considerations, all registration statements for new funds that would hold virtual assets which would have gone automatically effective were withdrawn. Subsequent to the January Expert Panel meeting, on January 18th, the staff issued a letter to the ICI and SIFMA detailing their concerns around cryptocurrency-related holdings.

3. Staff Accounting Bulletin (SAB) No. 118:

On December 22, 2017, the SEC announced publication of staff guidance for publicly traded companies, auditors, and others to help ensure timely public disclosures of the accounting impacts of the Tax Cuts and Jobs Act (the Act) recently signed into law. Specifically, the staff of the Office of the Chief Accountant and the Division of Corporation Finance issued the following interpretations:

a. Staff Accounting Bulletin (SAB) No. 118 expresses views of the staff regarding the application of U.S. GAAP when preparing an initial accounting of the income tax effects of the Act.

b. Compliance and Disclosure Interpretation 110.02 expresses views of the staff regarding the applicability of Item 2.06 of Form 8-K with respect to reporting the impact of a change in tax rate or tax laws pursuant to the Act.

Under the staff guidance in SAB 118, companies may report provisional amounts in their financial statements based on reasonable estimates for items for which the accounting is incomplete. A company that cannot make a reasonable estimate for an income tax effect should not account for that effect until the first reporting period for which it can make such an estimate. Any provisional amounts recorded either initially or subsequent to the reporting period that includes the Act's enactment date may be subject to adjustment during a measurement period where an entity obtains, prepares, and analyzes the information needed to complete the accounting requirements under ASC 740 that should not exceed one year beyond the enactment date. The staff's guidance also describes supplemental disclosures about the material financial reporting effects of the Act for which the accounting under ASC 740 is incomplete.

Following issuance of SAB 118, the Division of Investment Management confirmed in Information Update 2017-07 (IM-INFO-2017-07) that investment companies can rely on SAB 118 guidance for purposes of calculating their daily NAV and reporting measurement period adjustments. The IM-INFO-2017-07 also noted that each registrant must disclose relevant information to investors to provide information about the material impacts of the Act to its calculation of NAV and material provisions for which the accounting is incomplete, if applicable. The disclosure about those impacts may be made in a press release, website disclosure, or some other reasonable manner.

The SEC staff further noted that FASB staff issued a Q&A indicating that the FASB staff would not object to private companies applying SAB 118 and that those private companies applying SAB 118 would be in compliance with GAAP. The Q&A also states that private companies applying SAB 118 should apply all relevant aspects of SAB 118 in its entirety including disclosures and such private companies should disclose their accounting policy of applying SAB 118 in accordance with ASC 235-10-50-1 through 50-3.

4. Frequently asked questions (FAQs) for Liquidity Rules

The staff of the Division of Investment Management has prepared responses to frequently asked question related to the investment company liquidity risk management program requirements.

Investment Companies Expert Panel

Highlights of the February 20, 2018 Panel call with the SEC staff for the Division of Investment Management

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the call:

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1. **Investment Company Reporting Modernization implementation discussion:**

   The SEC staff of the Division of Investment Management (SEC staff) is performing a targeted review to assess registrants' compliance with the S-X amendments in connection with the Investment Company Reporting Modernization final rule adopted in October 2016 and effective for periods ending after August 1, 2017. The SEC staff has observed variation in implementation for certain disclosure requirements within the following four thematic areas:

   a. ***Agreement of Article 12 Schedules to Balance Sheet (§210.12-12 – 12-14):***

      A note instruction to certain of the schedules in Article 12 requires that the total of certain columns agree with correlative amounts shown on the related balance sheet including the following generally:

      - For investments in securities and options, the total value on the schedules should agree with correlative amounts on the balance sheet.
      - For investments in derivatives, generally the total unrealized appreciation and depreciation on the schedules should agree with correlative amounts on the balance sheet.

- However, there is no such requirement for the schedule required by rule 12-13A Open futures contracts; although registrants may elect to do so.

A reconciliation demonstrating that agreement may assist a reader in understanding how the information in the schedules affects the NAV of a fund.

For example, rule 12-13C Open swap contracts, note instruction 7, states that the total of the upfront payments/receipts and the total of the unrealized appreciation/depreciation should agree with the total of correlative amount(s) shown on the related balance sheet. However, the total of different amounts for different types of swap contracts may appear in numerous line items on the balance sheet for amounts such as upfront premiums paid/received, variation margin for centrally cleared swaps, and unrealized appreciation/depreciation for non-exchange traded swaps.

The adopting release discussed an example of how registrants may accomplish the agreement required by Article 12 by outlining one commenter's suggestion that the appreciation/depreciation for non-exchange traded derivatives such as forward foreign currency contracts and swap contracts be disclosed in two separate columns or include subtotals, rather than in one column. However, the requirement suggested by the commenter was not adopted in order to allow flexibility in the manner in which registrants meet the requirement, acknowledging that an extra column may not be necessary to comply.

The SEC staff noted that there may be various ways to demonstrate agreement and meet the objective of informing investors about how the schedules relate to the balance sheet including subtotals, reconciliation, or other qualitative disclosures, etc.; further, the SEC staff acknowledged that, in some cases where few columns or line items are presented either in the schedules or the balance sheet, additional disclosure may not be necessary in order to demonstrate agreement. The SEC staff did not prescribe one method over another and intends to comment on financial statements where the agreement of the schedules required by Article 12 with the balance sheet is unclear.

b. ***Required disclosures for affiliate investments table (§210.12-14):***

Q&A #5 of Regulation S-X section of the SEC staff Investment Company Reporting Modernization FAQs, released in July 2017, indicates that disclosures required by rule 12-14 of Regulation S-X regarding investments in and advances to affiliates may be presented in the schedule of investments (SOI) or in the notes to the financial statements. Rule 12-14 requires certain disclosures to be provided in the schedule of affiliated investments, including the categorization of investments by industry or geography, denoting restricted securities, securities valued using significant unobservable inputs, etc. The changes to rule 12-14 resulted in additional disclosure for affiliated investments.

The SEC staff observed that some registrants have not included information required by rule 12-14 if they have already provided such information in the SOI as required by rules 12-12 through 12-13D. The SEC staff observed that where a registrant's investments in affiliates are concentrated in an industry or geography, are restricted, or are valued using significant unobservable inputs, for example, it may be meaningful for investors to view that disclosure in aggregation on the affiliated investments schedule. Where there are a small number of affiliated holdings presented on a SOI with a small number of investments, for example, registrants may determine that such additional information may not be necessary to reasonably inform investors since it is easily identifiable on the SOI.

The SEC staff encourages registrants to evaluate facts and circumstances to determine whether that disclosure is meaningful to investors. The SEC staff intends to comment regarding how a registrant complied with the requirements of rule 12-14 if such information is missing and it believes it may be helpful for a reader to better understand the context of the registrant's affiliated investments.

c. ***Variable rate securities (§210.12-12 fn. 4,12-12A fn. 3, 12-12B fn. 3, 12-14 fn. 3) and derivatives with reference assets as variable rate securities (§210.12-12B fn. 5, 12-13 fn. 3, 12-13C fn. 3)***

In accordance with the footnotes to certain schedules in Article 12, variable rate securities should include a description of the reference rate and spread and either the end of period interest rate or the end of period reference rate for each reference rate described in the schedule.

The SEC staff noted variation on how registrants provided disclosures on variable rate securities and highlighted certain effective disclosures:

i. Step coupon bonds and securities with caps/floors:

- Effective disclosures identified included the current rate and date through which it is effective, the date when the rate steps up or down, and what the rate would be at those dates.
- Effective disclosure may also include qualitative description of the direction and range of rates where a bond has multiple steps and a registrant has determined that disclosure of each step would not provide additional significant information to an investor about the return profile.
- The SEC staff observed that disclosure indicating whether the rate will step up or step down, may be an important indicator of a different return profile in contrast to just showing one rate and the maturity date when that rate will not be earned through maturity.
- Similarly, for securities with caps and floors, the SEC staff observed effective disclosure concerning the existence and description of a cap/floor, as well as, the amount of the cap/floor. Disclosure of such information regarding a cap/floor may be indicative of a different return profile.

ii. Asset-backed securities:

- Where the effective interest rate is constantly changing based on performance of underlying assets, the SEC staff observed an effective disclosure that included disclosure of the current rate and disclosure about how the investment works (e.g., how payments are made).

iii. Bank loans with multiple tranches and weighted average rates:

- Where there are investments with different tranches and rates but for an investment which is depicted as one unit of account, the SEC staff observed effective disclosure which included additional information about the various rates rather than including only a weighted average rate.

iv. Derivatives where the underlying asset is a variable rate security:

- The SEC staff observed effective disclosure which included a description sufficient for a user to understand the terms of the payments to be received and paid, for example, in the case of an interest rate swap, disclosure where both the reference rate and spread, and either the end of period rate or the end of period reference rate for each reference rate described was disclosed in a note to the schedule.

The SEC staff may comment where disclosures are unclear or insufficient for an investor to understand the investment in consideration of the overall portfolio.

d. ***Custom baskets disclosures (§210.12-13 and 12-13C)*:**

Q&A #2 and 3 of Regulation S-X section of the SEC staff Investment Company Reporting Modernization FAQs discuss certain questions around disclosure of custom baskets. During the February 2018 call, the SEC staff highlighted certain additional observations concerning custom basket disclosure from discussions with registrants and from their review of registrants' financial statements.

The SEC staff discussed inquiries received:

- Specifically, regarding how registrants should treat notional values when custom baskets hold both long and short positions when determining whether a fund is required to disclose the components of the custom basket. Footnotes 3 in rules 12-13 and 12-13C states the following:

  > *If the reference instrument is an index or basket of investments, the components are not publicly available on a Web site as of the balance sheet date, and the notional amount of the option/swap contract does not exceed one percent of the net asset value of the registrant as of the close of the period, identify the index or basket. If the reference instrument is an index or basket of investments, the components are not publicly available on a Web site as of the balance sheet date, and the notional amount of the option/swap contract exceeds one percent of the net asset value of the registrant as of the close of the period provide a description of the index or custom basket and list separately: (i) The 50 largest components in the index or custom basket and (ii) any other components where the notional value for that components exceeds 1% of the notional value of the index or custom basket.*

  The SEC staff clarified that treating the notional values of the short positions of the custom basket in terms of their absolute values may be appropriate in order for a registrant to determine if the notional amount of the option/swap contract exceeds the threshold prescribed. The view that a fund should treat the notional values of short positions in terms of their absolute values when evaluating individual components to identify the top 50 largest components and any other components that exceed 1% of the notional value of the index or custom basket has already been expressed in Q&A #2 of Regulation S-X section of the SEC staff Investment Company Reporting Modernization FAQs.

The SEC staff shared additional financial statement review observations:

- Rule 12-13C, footnote 3, requires registrants to disclose the percentage value of the component when compared to the custom basket net assets:
  - While the SEC staff believes that the use of a component's "value" in the numerator is clear, they acknowledged there have been questions about what the "custom basket's net assets" (the denominator of the calculation) represents.
  - The SEC staff observed some registrants utilizing the value of the derivative as the denominator in the calculation.
  - The SEC staff observed some registrants disclosing the percentage value as a component of the fund's net assets, similar to the requirement in rule 12-12, footnote 5.
  - The SEC staff observed ineffective disclosure where a percentage is presented but it is unclear what the percentage represents.
  - Without further published guidance, the SEC staff intends to be flexible but may comment where disclosure is unclear or does not provide meaningful information.
- Rule 12-13C, footnote 3, requires registrants to disclose the 50 largest components and any other components where the notional value of the component exceeds 1% of the notional value of the basket.
  - The SEC staff observed disclosures where it is difficult for a reader to determine how the components of the basket that are disclosed relate to the derivative as a whole.

- The SEC staff observed effective disclosure where registrants are only providing the top 50 components and any component whose notional > 1% of the basket's notional and:
    - The registrant identified that the disclosure represented a subset of the basket (e.g., top 50 and > 1%) and not all of the contents of the basket were included; and/or,
    - Included a line item encompassing the totals of "other components" to agree to the total value of the swap.

Investment Companies Expert Panel

March 13, 2018 Conference Call

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the call:

I. Accounting/Reporting Issues:

1. The Expert Panel (EP) members discussed the SEC staff comments provided during the February EP conference call regarding implementation of Regulation S-X amendments.

2. The EP discussed the accounting treatment of investment research costs under the second Markets in Financial Instruments Directive (MiFID II) for U.S. entities. One of the directives under MiFID II is the unbundling of commissions into execution and research costs. Historically, investment research provided to the asset manager by a broker-dealer or a bank has not been a separately identifiable cost and has been bundled within trading commission rates.

ASC 946-320-30-1 states, "An investment company shall initially measure its investments in debt and equity securities at their transaction price. The transaction price shall include commissions and other charges that are part of the purchase transaction." Accordingly, investment companies typically capitalized these commission transaction costs into the cost basis of the security purchased. One of the goals of MiFID II regulation is to provide greater transparency into execution and research costs. The firms may not be able to link research costs to transaction volume or transaction value.

The EP considered whether research costs under MiFID II would qualify as direct incremental transaction costs that can be capitalized. When considering whether or not such costs can be capitalized an entity would need to consider if the research cost can be linked directly to a transaction. The EP members will discuss with asset managers to better understand current practice and what options for accounting treatment may be available. The EP will revisit at a future meeting.

3. During the May 2017 EP meeting, the EP noted that they believe investment companies may be impacted by guidance in FASB ASU 2016-13 *Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (CECL)* and have highlighted several broad areas for investment companies as potentially being affected by this ASU. One of the topics discussed at the July and November 2017 EP conference calls was beneficial interests accounted for under FASB ASC 325-40 and the related creation and release of an allowance account for all future expected credit losses. During the November 2017 EP conference call, the EP noted that generally an investment company would record interest income based on the interest method and would update the effective yield based on expectations of timing and the amount of cash flows to be collected.

During the March 2018 EP conference call, the EP revisited this topic, as there has been discussion within the industry on the application of ASC 325-40 to beneficial instruments reported at fair value through net income. These discussions have focused on the impact of the application of ASC 325-40 to income statement geography (i.e., interest income vs. unrealized/realized gains and losses).

ASC 325-40-15-7 indicates that beneficial interests classified as trading are within the scope of ASC 325-40 for purposes of income recognition:

> "For income recognition purposes, beneficial interests classified as trading are included in the scope of this Subtopic because it is practice for certain industries (such as banks and investment companies) to report interest income as a separate item in their income statements, even though the investments are accounted for at fair value."

ASC 325-40-15-1 states:

> The guidance in this Subtopic applies to all entities.

There is no additional guidance in ASC 325-40 that is specific to securities that are recorded at fair value through net income. Previous guidance in ASC 325-40-35-2 had indicated that the same amount of interest income shall be recognized each period regardless of whether the beneficial interest is classified as held to maturity ("HTM"), available for sale ("AFS") or trading.

> "The method used for recognizing and measuring the amount of interest income on a beneficial interest shall not differ based on whether that beneficial interest is classified as held to maturity, available for sale, or trading debt security. The same amount of interest income shall be recognized each period regardless of whether the beneficial interest is classified as held to maturity, available for sale, or trading debt security."

However, that guidance has been superseded by ASU 2016-13. ASU 2016-13 added new guidance for how to account for changes in cash flows expected to be collected for HTM and AFS securities, but no additional guidance was added specifically for trading securities.

ASC 325-40-35-1 would appear to apply to trading securities (as well as HTM and AFS), it states:

> "The holder shall recognize accretable yield as interest income over the life of the beneficial interest using the effective yield method. The holder of a beneficial interest shall continue to update, over the life of the beneficial interest, the expectation of cash flows to be collected."

BC96 of ASU 2016-13 also appears to be relevant, it states:

> "The Board also acknowledges that practice related to interest income recognition on beneficial interests within the scope of Subtopic 325-40 will be different when the allowance for credit losses is present. When a beneficial interest within the scope of 325-40 has an allowance for credit losses, favorable or unfavorable changes in cash flows must first be considered as adjustments to the allowance for credit losses. Only the remaining portion of favorable or unfavorable changes in cash flows would be reflected in accretable yield."

The EP members discussed whether an investment company that holds a beneficial interest should maintain an allowance for credit losses for beneficial interests or should future cash flows be adjusted through interest income and/or unrealized/realized gains and losses. Specifically, the EP members discussed the following views:

View A – The entity should maintain an allowance for credit losses.

Proponents of View A believe that ASC 325-40 has and continues to be an integrated interest income and impairment model. The amount of interest income that a company records, and the degree to which the effective yield is updated on a prospective basis, depends first on whether or not an adjustment to the allowance for credit losses (either on a favorable or unfavorable basis) would be required. The model does not work unless a company is applying both the interest recognition and the impairment model.

Proponents of View A do not believe that the deletion of the guidance indicating interest income should be the same for available-for-sale, trading and held-to-maturity securities is determinative that the impairment model does not apply to instruments reported at fair value through net income. Interest income may be different between classes of securities because the impairment models for AFS and HTM are different. In addition, the bifurcation of derivatives from an AFS or HTM security would make interest income different from a trading instrument where such bifurcation is not required.

Some proponents of View A would require a security measured at fair value through net income subject to 325-40 to apply the AFS impairment model in ASC 326-30. Other proponents of View A would permit an accounting policy choice to apply either the AFS impairment model (ASC 326-30) or the HTM impairment model (ASC 326-20).

Proponents of View A note that an entity should also have a policy for charging off allowance balances against the amortized cost basis of the instrument.

Some proponents of View A believe that the allowance does not need to be separately included on the face of the balance sheet and that changes in the allowance do not need to be separately reported in the income statement as the instrument is carried at fair value with all changes recorded in net income. Other proponents of View A believe that the allowance should be separately reported in the financial statements consistent with how HTM or AFS allowances will be reported.

View B – The entity should not maintain an allowance for credit losses.

Proponents of View B believe that the computation of an allowance for credit losses is not required for instruments reported at fair value through net income, even for instruments subject to ASC 325-40. Under this approach, all changes in future estimated cash flows would result in prospective yield adjustments.

Some proponents on View B believe that, in situations involving a decline in cash flows that there should be some limitations on prospective yield adjustments. For example, some proponents of View B do not believe that the effective yield should be reduced below 0%.

Proponents of View B point to the lack of any discussion in ASC 325-40 about trading securities requiring an allowance as evidence that it is not required. Proponents of View B also note that ASC 325-40 directs companies to ASC 326-20 for HTM investments and ASC 326-30 for AFS investments to determine impairment. 326-20-15-3 states that the guidance in this subtopic does not apply to instruments reported at fair value through net income. Similarly 326-30-15-2 limits the applicability of that subtopic to instruments classified as available-for-sale.

Some proponents of View B point to the language in BC96

> "When a beneficial interest within the scope of 325-40 has an allowance for credit losses, favorable or unfavorable changes in cash flows must first be considered as adjustments to the allowance for credit losses."

which acknowledges that a beneficial interest may not have an allowance for credit losses as support for View B. They believe that this language was not referring only to situations where an event that would have required the establishment of an allowance had not occurred.

Differences in views

At a high level (setting aside some specific issues if the available-for-sale impairment model as opposed to the held-to-maturity impairment model is applied), in a number of circumstances the differences in these views can be summarized as follows:

- Decline in cash flows:
  - Under View A, if a decline in cash flows would cause an impairment, yield would not be adjusted and instead, the company would record an allowance for credit losses.
  - Under View B, it would be treated as a prospective yield adjustment.
- Increase in cash flows – both View A and View B would have prospective yield adjustment.
- Increase in cash flows after there was a previous decline in cash flows:
  - Under View A, the increase in cash flows would result in the reversal of the allowance and only result in a yield adjustment after the allowance is reversed.
  - Under View B, the yield would adjust.

The EP members will consider Views A and B presented and will reconvene on this topic at a future meeting.

4. During the January 2018 meeting, the EP discussed the accounting for various loan fees that are received by BDCs or other types of funds with lending activities. Examples of these types of loan fees received by such entities include origination and upfront structuring fees, syndication fees, commitment fees, amendment or restructuring fees and prepayment fees. The EP discussed whether funds are adopting the new revenue recognition guidance in ASC 606 for these fees or whether they are applying ASC 310-20 by analogy or other guidance. The EP continued this discussion during the March EP conference call. EP members believe that these types of loan fees collected by BDCs or similar funds with lending activities are more associated with financial instruments and would generally fall outside of ASC 606; thus, ASC 310-20 would generally be more appropriate for these investment companies.

5. The SEC staff inquired whether the EP has been discussing accounting and presentation of EU tax reclaims or has formed any views given we are seeing some variance in practice. For more information, refer to the SEC Staff Update below.

6. The EP considered accounting for a business development company consolidating a wholly owned subsidiary. A BDC purchases 100% of a finance company that historically was not considered to be an investment company. After the acquisition, the operations of the finance company continue to be separate from the operations of the BDC. FASB ASC 946-810-45-2 states that consolidation by an investment company of an investee that is not an investment company is not appropriate. FASB ASC 946-10-25-1 states that an entity shall reassess whether it meets (or does not meet) the assessment of investment company status in paragraphs 946-10-15-4 through 15-9 only if there is a subsequent change in the purpose and design of the entity. However, ASC 946-810-45-3 provides guidance for when an investment company should consolidate an operating company that is not an investment company, but provides services to the investment company, such as investment adviser or transfer agent services, and the purpose of the investment is to provide services to the investment company, rather than realize a gain on the sale of the investment. If the investment company holds a controlling financial interest in the operating company that provides services to the investment company, it should consolidate the entity rather than measuring the interest at fair value. Further, SEC IM Guidance Update 2014-11 states that a BDC should consolidate a wholly owned subsidiary when the design and purpose of the subsidiary is to act as an extension of the BDC's investment operations and to facilitate the execution of the BDC's investment strategy.

The EP noted the following questions would be relevant to the determination whether or not the BDC should consolidate the wholly owned finance company:

a. What is the purpose and design of the finance company?

b. Does the BDC have any other similar investments?

c. Is this investment in a finance company different from other BDC's investments? How?

d. Does the finance company appear to act as an extension of the BDC?

e. Does the finance company have employees?

f. Is the BDC a passive investor in the finance company?

g. Is the BDC investing in the finance company to get access to a portion of the loan market that the BDC hasn't traditionally had which gets integrated into the BDC's operations?

h. Is the finance company a regulated entity?

i. Who is going to manage the finance company?

j. Does the finance company have an independent board?

k. Is employee compensation for the finance company separate from employee compensation for the BDC?

l. Is there an exit plan for the BDC's investment in the finance company?

The EP members discussed that whether or not the BDC consolidated the wholly owned finance company would depend on the facts and circumstances. An important factor in reaching the conclusion would be the consideration of an exit strategy for the finance company.

7. The EP considered a question regarding nonregistered investment companies with ownership interests in the form of debt. FASB ASC 946-10-55-26 states "In addition, having significant ownership interests that are not considered equity interests in accordance with other Topics (for example, ownership interests in the form of debt) does not necessarily preclude an entity from being an investment company provided that the holders are exposed to variable returns from changes in the fair value of the underlying investments of the entity. The economic substance of the entity, rather than its legal form, should be evaluated to determine whether the entity has that characteristic of an investment company." As a result, certain entities (such as a CDO or CLO) with ownership interests in the legal form of debt may be considered to be investment companies.

The EP discussed the financial statement presentation impact on the schedule of investments and the financial highlights for these types of investment companies (nonregistered). The EP noted that although FASB ASU No. 2013-08 stated that having ownership interests of the investment company could be in the form of equity or debt, it did not consider implications for the schedule of investments and the financial highlights of ownership in the form of debt.

The entity would also consider how material debt holders are to the fund, and whether debt ownership and equity ownership should be treated as one or separate legal classes.

II. Audit and Attest Issues

1. During March EP conference call, the EP members shared that they continued discussions within their organizations regarding an independent public accountant's responsibility under the attestation standards to test the completeness of the population of client accounts over which the registered investment adviser (RIA) is considered to have custody when performing an independent verification (surprise exam) of client funds and securities under the Custody Rule. The EP members noted that whether a RIA is deemed to have custody of a client account under the custody rule is a legal determination. The EP members also noted that as part of the surprise exam, the accountant should understand the client's process and controls for determining which accounts they have custody of (including the clients' consultation with legal counsel, as applicable) and therefore which accounts are included in the population of accounts within the scope of the surprise exam. The EP will revisit this topic at its May meeting.

III. SEC Staff Update

Disclaimer

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1. The SEC staff discussed Custody Rule related matters pertaining to the SEC's no-action letter on the use of standing letters of authorization (NAL). The SEC staff acknowledged there have been questions about material non-compliance notification requirements and potential surprise exam opinion qualifications, for both historical surprise exams and prospective surprise exams as it relates to clients for which standing letters of authorization (SLOA) exist. The SEC staff indicated they did not originally anticipate a significant number of notifications or opinion qualifications as a result of the NAL. Ultimately, the determination of a material non-compliance or a qualification of the surprise exam opinion is up to the auditor's judgement. For material non-compliance notifications or qualifications of surprise exam opinions related to clients under SLOA, the SEC staff recommends using clear, standardized language either in the notification or in the qualified opinion, so that the source of the notification or qualification relating to SLOA specifically is evident.

2. The Internal Revenue Service Notice 2016-10 addresses the treatment of foreign withholding tax refunds received by U.S. regulated investment companies (RICs) due to recent court rulings that were favorable to RICs, where certain European countries have paid refunds (reclaims) of dividend withholding taxes previously withheld by these European countries. The Notice provides RICs with two alternative reporting methods under certain conditions: netting the reclaims against current foreign withholding tax or obtaining a closing agreement to estimate aggregate adjustments due (and pay a related closing fee).

The SEC staff discussed the accounting treatment and presentation of compliance fees paid to the IRS and professional fees paid to accountants and lawyers to assist funds in receiving these reclaims where the closing agreement path is selected. The SEC staff has seen diversity in practice in presentation of the professional fees and compliance fees on the income statement, as some funds net these fees against dividend income, while others treat these fees as operating expenses. The SEC staff noted that they have observed some cases where the fees are neither broken out separately on the income statement nor separately disclosed in the footnotes, which may be due to materiality.

The SEC staff acknowledged the variance in current practice, noting the conclusion may depend on facts and circumstances, and indicated that they may comment on the accounting framework utilized.

3. The SEC staff offered the following comments on crypto assets:

a. The SEC staff of Investment Management Division issued a letter to ICI and SIFMA on cryptocurrency and fund innovation. The letter identified some questions the Division had around existence, valuation, custody, liquidity and arbitrage for registered investment companies proposing to invest in crypto assets and related products. The SEC staff is focused on, among other things, the following accounting and auditing questions:

- Existence – How does an entity validate the existence of cryptocurrency? How are private keys stored and how is exclusive ownership or control of the keys validated?

- Valuation – How do funds approach valuation of cryptocurrency in accordance with ASC 820? The SEC staff is interested in how the principal or most advantageous market concepts are being applied, given there are many markets which may be volatile and fragmented, which includes how market selections are being made and how frequently they are being reassessed.

b. The SEC staff indicated that issues related to crypto assets are a focus of the Division and the SEC IM staff is working closely with the Division's Analytics Office to identify targeted areas of interest and certain funds for targeted reviews. The SEC staff performs targeted reviews of funds investing in Fintech instruments. Part of the focus of these reviews is on funds invested in instruments that would give exposure to crypto assets (e.g., grantor trusts or similar vehicles) and how the funds' accounting policies address significant events like forks or air drops. The SEC staff noted several factors to consider for investment companies invested in these instruments, including initial and subsequent fair value measurements in accordance with current fair value policies and procedures and whether operationally and legally the fund is positioned to receive such assets. The SEC staff also highlighted a focus on tax considerations and whether or not crypto assets would be considered non-qualifying assets under subchapter M.

other expert assistance is required, the services of a competent professional should be sought.

Investment Companies Expert Panel

May 15, 2018 Meeting

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the meeting:

I. AICPA/Administrative:

1. The Expert Panel (EP) March 2018 call highlights are being finalized.
2. The EP members considered certain AICPA Audit and Accounting Guide *Investment Companies* (the Guide) matters.

II. Accounting/Reporting Issues:

1. One EP member inquired if there were any additional implementation issues relating to Investment Company Reporting Modernization. The EP was not aware of any new developments. EP members shared that certain registrants received financial statement review comments that were either exploratory in nature or related to reconciling financial statements to prospectus and overall consistency in filings and disclosures. Certain EP members shared that financial statement review comments they had observed were similar in nature to those shared by the SEC staff in the February 2018 EP meeting.
2. Interest paid to private equity funds – Private equity funds often have multiple closes of investors where the later subscribed investors may have to pay "interest" to the earlier subscribed investors. These amounts may be paid to investors outside the private equity fund or as an additional payment into the fund and allocated to the earlier subscribed investors. ASC 946-320-30-1 states "An investment company shall initially measure its investments in debt and equity securities at their transaction price. The transaction price shall include commissions and other charges that are part of the purchase transaction." The EP discussed that if the interest charge is paid by a fund of funds into an underlying private equity fund (and allocated specifically to earlier subscribed investors), a fund of funds that subscribes to a later close may record the "interest" paid as an adjustment to the cost basis of its investment, essentially paying a premium to NAV. One EP member noted that from an income tax perspective, this could be an interest expense. Certain EP members believed it was more appropriate to record the charge through the fund of fund's statement of operations as an unrealized loss.
3. Investment company determination for carried interest vehicle – Advisers of private equity funds often set up separate legal entities to invest as a limited partner in the private equity funds they manage. The adviser may also set up a separate legal entity for the benefit of its employees who are able to invest in the private equity fund and receive a portion of the carried interest. ASC 946-10-55-21 states "Having investors that are related parties of the parent or the investment manager does not necessarily preclude an entity from being an investment company. For example, an investment manager may form an investment company for its employees in conjunction with another investment company. Although the employees may be related parties of the investment manager, the investment company formed for its employees mirrors the business purpose and activities of the main investment company."

The EP members considered a scenario where an adviser gave its employees the ability to invest in a private equity fund, via an employee-only fund- that was also receiving a portion of the carried interest earned by the adviser. The majority of the earnings in the employee only fund were from its portion of carried interest, rather than from investing activities. The EP members discussed whether the separate legal entity that is held by employees may be considered an investment company or an extension of the adviser (i.e., an operating company). The EP members expressed a view that since the economics of the employee-only fund are more heavily skewed towards the carried interest it earns, it would appear this legal entity is acting as an extension of the adviser of private equity funds (i.e., an operating company), rather than as an investment company.

4. The EP considered basis of presentation and unit of account issues as it relates to special purpose vehicles (SPVs) and blockers (i.e., separate legal entities between the fund and the portfolio company). Blockers are usually created for the benefit of the investor and are often bundled with the underlying portfolio company upon exit of the investment.

In determining whether such entities are accounted for as an investment at fair value or consolidated by an investment company, the ownership (wholly owned versus multiple owners) and number of investments would be considered, among other factors, to determine if the entity is an investment or if it is an extension of the investment company.

III. Audit and Attest Issues

1. The EP discussed the auditor's report on mutual fund or separate account financial statements when reporting on numerous funds/subaccounts within one report (under the recently effective PCAOB AS 3101), specifically as it relates to all reporting entities and periods covered by each statement. Certain EP members noted they add a table between first and second paragraph of the report to identify numerous funds/subaccounts and periods for each, or add an appendix to the opinion.

2. The PCAOB standard on new audit report model states:

> "Because of the unique structure of investment companies, which typically includes common accounting, internal control, and oversight functions at the group level, the reproposed standard required that, for an investment company that is part of a group of investment companies[82], the auditor's statement regarding tenure will contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies."

[82]: "A group of investment companies, as defined by Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"), means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. For purposes of determining auditor tenure, any tenure with other entities that may be part of an investment company complex, such as investment advisers or private investment companies, is not included."

The EP discussed that generally, only registered investment companies would fall under the definition of "investment company group" in practice. The EP also considered how audit firms are thinking about the auditor tenure disclosures where the funds have been acquired and have either same or different auditors. The EP noted the importance of judgement and acknowledged determination would be based on facts and circumstances.

3. The EP continued discussing testing the completeness of population of accounts over which the registered investment adviser (RIA) is considered to have custody when performing a surprise examination and acknowledged it is a legal determination. The EP members agreed that the auditor carries a certain level of responsibility to understand the RIA's process to identify and determine which accounts would be subject to the custody rule, and therefore included in the population.

4. With respect to auditing implications relating to cryptocurrencies, including testing of existence and valuation, the EP members shared that for operating companies while some believe cryptocurrency is an intangible asset (as acknowledged by certain non-investment company registrants from discussions with OCA), for the investment company industry, cryptocurrency may be considered "other investments" which are recognized at their transaction price in accordance with ASC 946-325-30-1 and subsequently measured at fair value in accordance with ASC 946-325-35-1. The EP plans to monitor activities of various organizations' task forces on digital assets. Also see SEC Staff Update portion of these meeting highlights for additional information on this topic.

5. Custody rule and combined financial statements – For purposes of a registered investment adviser relying on the audited financial statement provision of the Custody Rule, Rule 206(4)-2(b)(4) specifies that the financial statements be prepared in accordance generally accepted accounting principles. The question has been raised regarding whether audited combined financial statements of multiple pooled investment vehicles (PIVs) may be used to satisfy the Custody Rule. ASC 810-10-55-1B states "There are circumstances, however, in which combined financial statements (as distinguished from consolidated financial statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management." As part of a single offering to investors, an adviser may set up separate legal entities for legal, tax, regulatory or other business reasons. Since these funds invest in identical investments, the adviser may determine that combined financial statements are more meaningful than the separate legal entities since they were formed in conjunction with each other. The EP members considered whether audited combined financial statements of multiple PIVs may be used to meet the requirements of the Custody Rule if they are prepared in accordance with generally accepted accounting principles. The EP noted that whether combined financial statements meet the requirements under the custody rule represents a legal determination that each investment adviser will have to make based on its particular fact pattern.

6. An EP member inquired whether, under the Custody Rule, a co-investment vehicle is considered a RIA's client, and whether the RIA is deemed to have custody of the funds of a co-investment vehicle. Further, is a surprise examination under Rule 206(4)-2(a)(4) of the Investment Advisers Act of 1940 required for co-investment vehicles? In such cases, participation is at the discretion of the investor and invests directly into an intended investee. The RIA is merely acting as a facilitator for the co-investor and does not have authority to utilize the funds of the co-investor for any other purpose.

At the May EP meeting, EP members observed that definition of an advisory client is a legal determination. EP members have seen private equity funds that have audits of co-investment vehicles to satisfy the surprise examination requirement of the Custody

Rule, even for those co-investment vehicles without management fees and carried interest.

IV. SEC Staff Update

Disclaimer

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1. Operations Related:

a. Master/Feeder Presentation:

The SEC staff reminded registrants about the requirements included in the 1998 “Dear CFO” letter and IM Guidance Update No. 2014-11, regarding the presentation for financial statements in a master-feeder structure:

> For an investment company registered under the Investment Company Act of 1940 (RIC) that is a feeder fund in a master-feeder structure, unconsolidated financial presentation is generally the most meaningful presentation, provided that, among other things, the feeder fund attaches the financial statements of the master fund to the feeder fund’s financial statements.

The SEC staff recently had discussions with a feeder fund which invested substantially all of its assets in an unaffiliated master fund. The master fund was a registrant under the Investment Company Act of 1940 (1940 Act), but not the Securities Act of 1933 (1933 Act). The feeder fund was registered under both the 1933 and 1940 Acts. Rather than attaching the master fund’s financial statements to the feeder fund’s financial statements, the feeder fund directed investors to the location of the master fund’s financial statements on the SEC website. The feeder fund did not attach the master fund’s financial statements due to concerns around certifying the unaffiliated master fund’s financial statements. The SEC staff noted that in order for the feeder fund’s financial statements to be complete, the master fund’s financial statements should be attached. The SEC staff also noted that when the master fund is unaffiliated, certain registrants believe it is important to include the certification of the master fund’s financial statements, signed by the certifying officer of the unaffiliated master fund. For example, the staff noted that they have observed in practice that certain feeder fund registrants have included a certification relating to the unaffiliated master fund’s financial statements in the feeder fund’s N-CSR filing.

b. Accounting for digital assets:

- The SEC staff shared that even though they are not seeing direct investments in digital assets, like cryptocurrencies, in registrants’ portfolios, certain registrants have indirect exposure, as they have invested in a grantor trust or a similar vehicle that holds within its portfolio bitcoin or other digital assets. The staff cautioned that registrants with indirect exposure should be monitoring these investments for significant events that may impact the value of their investments or may cause another recognition event in the registrant’s books and records.

For example, the staff noted that in Q4 of 2017, the bitcoin network experienced multiple “hard forks.” The staff described a particular scenario where a registered fund invested in a grantor trust holding bitcoin, and the bitcoin network experienced a “hard fork.” On October 24, 2017, when bitcoin forked, the grantor trust was entitled to receive one bitcoin gold for each bitcoin it held (and retain its bitcoin). After the fork, the grantor trust had to determine how to account for the rights to bitcoin gold, including whether it should be recognized in the trust’s books and records, and if so, at what value. After the fork, the SEC staff observed that funds that invested in the grantor trust continued to fair value their investment in the grantor trust based off the traded value in the over-the-counter markets. On November 22, 2017, the grantor trust established a record date and declared a distribution as a result of the bitcoin gold fork. The grantor trust then distributed the rights to its bitcoin gold to an agent who ultimately obtained and sold the bitcoin gold, then made cash distributions to the trust’s investors. The staff observed that a fund registrant investing in this grantor trust did not reflect the distribution in its books and records as of the record date. The SEC staff shared that this registrant subsequently amended and restated its semi-annual financial statements to recognize the distribution related to the bitcoin gold fork on the record date.

The SEC staff advises that registrants with indirect investments in cryptoassets must monitor significant events that may impact the fair value of its direct investments, and if direct investment vehicles declare distributions, the registrant should determine 1) whether a recognition event has happened, 2) what they received, and 3) its value.

- The SEC staff has not received a consultation submittal from an investment company related to characterization of digital assets at this point, but noted that if an entity determines it is an investment company, the investment company-industry specialized accounting, including application of ASC 946 and the measurement of investments at fair value under ASC 820, would generally apply. The SEC staff and the EP both would generally expect that investment companies would consider digital assets to be “other investments” which are recognized at their transaction price in accordance with ASC 946-325-30-1 and subsequently measured at fair value in accordance with ASC 946-325-35-1.

c. Other Filing Updates - the SEC staff informed that Investment Company Reporting Modernization Frequently Asked Questions (Compliance Dates and General Filing Obligations, FAQ 8) has been updated to indicate that a fund with a fiscal year falling on October 31 or November 30, 2018 (and its mid-year falling on April 30 or May 31, 2018) does not need to file the fund’s mid-year filing on Form N-SAR because reports on Form N-CEN, which is an annual report, will encompass the mid-year period ending on April 30 or May 31, 2018, and Form N-SAR will be rescinded on June 1, 2018. The fund is expected to file Form N-CEN for the fiscal year ended October 31 or November 30, 2018.

d. Use of Data - In her recent speech at 2018 ICI conference and Remarks at the PLI Investment Management Institute 2018, Dalia Blass, the Director of Division of Investment Management discussed use of data. In the first, Ms. Blass described the staff’s internal tool called MAGIC which is an acronym for Monitoring and Analytics GUI for Investment Companies.

   Ms. Blass indicated “MAGIC allows us to pull together a number of data sets – including data from registrants and other sources – and look at it holistically. The tool combines performance, flow, holdings and other information and allows us to ask questions such as how does this fund’s portfolio compare to its strategy? Are its holdings aligned with its investment restrictions?”

   The SEC staff noted that so far, the tool has been effective in assisting the SEC staff with their disclosure review process, making reviews more efficient and effective. It allows the SEC staff to quickly identify entities that may have exposure to certain assets (e.g., indirect exposure to digital assets), as well as allows the SEC staff to implement a risk-based approach for its reviews. It also provides the SEC staff with data on asset flow, holdings and other information and indicates how the fund’s portfolio compares to its investment strategy. The staff noted that MAGIC incorporates data that is publicly available, such as mutual funds’ data in the prospectus that is filed with the SEC in an XBRL format and will incorporate N-PORT data once available.

2. Policy Related:

a. Disclosure Effectiveness/Shareholder Experience - A comprehensive list of rulemakings the SEC staff is working on is included in the agency rule list published semi-annually by the Office of Information and Regulatory Affairs and the Office of Management and Budget. The Spring 2018 Agency Rule List has been posted. Among Chairman Clayton’s short-term agenda items are amendments to financial disclosures about acquired businesses, disclosure update and simplification, auditor independence with respect to loans or debtor-creditor relationships, exchange-traded funds, investment company reporting modernization - option for website transmission of shareholder reports, personalized investment advice standard of conduct, fund of funds arrangements, use of derivatives by registered investment companies and business development companies, and fund retail investor experience and disclosure request for comment.

b. Valuation Guidance - The SEC’s Office of the Chief Accountant and the Division of Investment Management are soliciting recommendations for updates to guidance in ASRs 113 and 118 on the valuation of portfolio securities and other assets held by registered investment companies, including auditing and governance considerations.

c. The SEC proposed a rule “Auditor Independence with Respect to Certain Loans of Debtor-Creditor Relationships” that would amend the SEC’s auditor independence rules, specifically related to rule 2-01(c)(1)(ii)(A), better known as “the loan provision.” The proposal outlines four amendments that would effectively identify those debtor-creditor relationships that could impair an auditor’s objectivity and impartiality, yet, would not include certain extended relationships that are unlikely to present threats to objectivity and impartiality. The amendments would primarily:

   1. Focus the analysis solely on beneficial ownership;
   2. Replace the existing 10 percent bright-line shareholder ownership test with a “significant influence” test;
   3. Add a “known through reasonable inquiry” standard with respect to identifying beneficial owners of the audit client’s equity securities; and
   4. Amend the definition of “audit client” for a fund under audit to exclude from the provision funds that otherwise would be considered “affiliates of the audit client”.

Investment Companies Expert Panel

July 17, 2018 Conference Call

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the call:

I. AICPA/Administrative:

1. The Expert Panel (EP) March 2018 call and May 2018 meeting highlights are being finalized. The EP also considered EP-developed nonauthoritative guidance that should be retained on the EP webpage on aicpa.org.
2. The AICPA Product Development staff provided an update on status and timing of the 2018 AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. Bond Amortization – FASB ASU No. 2017-08, *Receivables–Nonrefundable Fees and Other Costs (Subtopic 310-20)*, requires the premium on a purchased callable debt security be amortized to the call price on its earliest call date. One EP member suggested the EP consider the journal entries that will be made upon adoption of the standard, the effect on those journal entries on the components of capital, and the disclosures that would seem to be appropriate for an investment company under the ASU. The EP will continue discussing this at September EP meeting.

III. SEC Staff Update

Disclaimer

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1. The SEC staff shared that to date, they received about 30 comment letters on the SEC proposed Rule "Auditor Independence with Respect to Certain Loans of Debtor-Creditor Relationships".
2. The SEC staff discussed unitary fees, which are generally asset-based fees paid by a fund (such as managed funds, managed exchange-traded funds and common collective trust funds) to its investment advisor for the provision of investment advisory and other fund expenses (e.g. custody fees, administrative and accounting fees, shareholder services fees, etc.). Typically, a fund will not show the components of these other fund expenses separately on the income statement, as the fund is paying the unitary fee only, which the advisor will use to pay those expenses. However, the SEC staff reminded registrants that to the extent an investment adviser is unable to pay these fund expenses, there is a risk to the fund as the service providers could stop providing services the fund needs to continue operations and this risk could warrant disclosure to the investors. Further, if the fund, as opposed to the investment adviser, chooses to pay the service providers directly (for example, to avoid suspension of a service arrangement by the service provider), the related receivable from the adviser for reimbursement of these payments should be properly recorded by the fund, its collectability evaluated, and the receivable settled in a timely manner in order to avoid noncompliance with provisions of the Investment Company Act of 1940 concerning loans between affiliated parties.

3. The SEC is monitoring fund filings related to various items, such as material weaknesses or missing opinions. Additionally, the SEC is focused on monitoring funds with potential exposure to emerging risks (indirect or direct), such as digital assets and funds with exposure to Argentina, due to the recent local currency devaluation.

Investment Companies Entities Expert Panel

September 20, 2018 Meeting Highlights

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the call:

AICPA Investment Companies Expert Panel

Meeting Highlights

September 20, 2018

I. AICPA/Administrative:

1. The Expert Panel (EP) March, May and July 2018 meeting highlights are available.
2. AICPA Audit and Accounting Guide *Investment Companies* (the Guide) has been released.
3. The EP considered dates for 2019 meetings.
4. The AICPA staff discussed volunteer applications for 2019 AICPA volunteer year. The application process closes October 1, 2018.

II. Accounting/Reporting Issues:

1. The EP discussed accounting for contingent common stock. A fund entered into an agreement with a public company for the purchase of restricted common stock, but the agreement had a provision that was contingent upon shareholder approval in conjunction with a pending merger. The fund could only purchase the shares of common stock if the shareholders of that company approved the pending merger. An EP member inquired whether the fund would meet the recognition guidance in FASB ASC 946-320-25-2 or FRR 404.04.a, which focus on an enforceable right to demand securities, and if the fund would record changes in the fair value of the public common stock to be received upon shareholder approval.

ASC 946-320-25-2:

A securities transaction outside conventional channels, such as through a private placement or by submitting shares in a tender offer, shall be recorded as of the date the investment company obtained a right to demand the securities purchased or to collect the proceeds of sale, and incurred an obligation to pay the price of the securities purchased or to deliver the securities sold, respectively. Determining the recording date may sometimes require an interpretation by legal counsel.

FRR 404.04.a:

Restricted securities should be included in the portfolio of a company and valued to determine current net asset value on the date that the investment company has an enforceable right to demand the securities from the seller.

Where the investment company negotiates the acquisition of the restricted securities directly with the owner of the securities, there are three significant dates. The first occurs when the investment company and the seller orally agree upon the price and the amount of the securities (the "handshake date"). At this point, there would not seem to be any enforceable right of the investment company to demand the securities from the seller since, in most states, particularly those which have adopted the Uniform Commercial Code, there is no enforceable right unless there exists some writing "sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price" (Section 8-319(a) of the Uniform Commercial Code). If the terms of the oral understanding do not contemplate compliance with any condition by the seller, it is suggested that the investment company procure, from the seller, a signed memorandum setting forth the price and quantity of securities to be sold. Upon receipt of that memorandum, an enforceable right would be obtained. The securities should be valued as of that date.

In those situations where the oral understanding contemplates the execution of a formal contract of purchase and sale, no enforceable right exists until the time the formal contract is signed (the "contract date"). If the formal contract does not require compliance with any conditions by the seller, an enforceable right is then obtained, and the securities should be valued as of that date.

Where the formal contract requires compliance with stated conditions which the investment company believes should not be waived, no enforceable right is obtained until the stated conditions are satisfied. In that situation, the valuation date should be the date upon which the conditions are satisfied (the "closing date").

The EP members expressed a view that since the purchase of securities would only be recorded upon the shareholders approving the merger, prior to obtaining this shareholder approval, the fund's right to demand securities [in accordance with aforementioned guidance] would not yet exist, and as such, only disclosure of the transaction would be appropriate. The EP members also discussed that entities should consider whether the contingency would be considered a derivative, similar to a contingent option.

2. The EP considered presentation of the financial statements for a fund's investments in affiliated funds. A fund invests solely in funds managed by the same adviser. These underlying funds may have similar investing strategies and may be set up as different legal entities for either tax, regulatory or operational reasons. The EP considered whether the fund of funds can aggregate the underlying funds for purposes of applying the guidance in ASC 946-210-45-7 and make the presentation of the financial statements similar to a master-feeder presentation.

<u>ASC 946-210-45-7:</u>

The reporting fund may list the investee (portfolio) funds directly on the statement of assets and liabilities. Additional disclosures may be required for those funds that hold a mixture of investments in other investment companies and direct investments in securities. However, there is usually no need for a separate schedule of investments. Fund management shall consider if an investment in a single underlying fund is so significant to the fund of funds as to make the presentation of financial statements in a manner similar to a master-feeder fund more appropriate.

The EP discussed that a fund that invests solely in affiliated funds could aggregate these underlying funds for the purposes of applying the guidance in ASC 946-210-45-7 and make the presentation of the financial statements similar to a master-feeder presentation, as long as such presentation is more meaningful and useful to the user of financial statements. In determining if such presentation is meaningful to investors, consideration should be given as to whether the investment strategies of the underlying funds are similar, how the disclosure of positions would be affected if the financial statements of the affiliated funds were combined, and how the underlying affiliated funds are marketed (that is, are they bound together or held out as separate entities). The EP also discussed that consideration should be given to whether or not the combined underlying funds would be viewed as a single reporting entity. Further, the EP noted that the presentation would depend on specific facts and circumstances.

Lastly, for entities relying on the audit provision of the custody rule, consideration should also be given on whether or not such presentation would comply with the custody rule.

3. The EP considered accounting for transaction costs. A fund has agreed in principle to purchase bank debt from a third party. In finalizing the agreement to purchase the bank debt, the fund has incurred legal costs to review and finalize the terms of the purchase agreement. The EP members discussed whether this type of cost may be included in the purchase price in accordance with FASB ASC 946-320-30-1:

<u>ASC 946-320-30-1:</u>

An investment company shall initially measure its investments in debt and equity securities at their transaction price. The transaction price shall include commissions and other charges that are part of the purchase transaction.

EP members observed that there is mixed practice in the industry with respect to what constitutes "other charges that are part of the purchase transaction" in ASC 946-320-30-1. EP members noted that consideration should be given to whether or not these costs are direct and incremental to the investment due diligence process and/or if these costs would be incurred regardless of whether the transaction was executed or not. If such expenses were incurred solely to allow closing of the specific transaction, the expense should be included in the transaction price. However, if the expense would be incurred regardless of whether the transaction occurs, then the expense should be expensed as incurred.

4. The EP discussed implementation matters related to the SEC Disclosure Update and Simplification Rule issued in August 2018. Specifically, the EP discussed the amendments to Rule 6-09.3 of Regulation S-X, which has been amended to require investment companies to present distributions to shareholders in total, except for tax return of capital distributions, which should be disclosed separately. These amendments replace the requirement to state separately distributions to shareholders from (a) investment income-net; (b) realized gain from investment transactions-net; and (c) other sources.

Update: Subsequent to the September 2018 EP meeting, the EP held supplemental discussions about whether the prior year distribution amounts disclosed on the statement of changes in net assets (SOC) in the prior year could be retrospectively presented to conform to the current year presentation resulting from the amended Regulation S-X requirements.

The EP members expressed a view that investment companies should be able to conform the presentation of the prior year's distribution amounts on the SOC to the current year's presentation on the SOC, as long as they include a footnote in the financial statements indicating the reason for the changing the prior year's SOC presentation and disclose the disaggregated distribution amounts from the prior year, so that the investors would still have the information available from the prior year's SOC. The EP members also suggested including the prior year's undistributed net investment income in the footnote, since it was technically required to be disclosed on the SOC in the prior year but is no longer required to be disclosed in the current year based on the Regulation S-X amendments. The EP members believe such presentation would be easier for investors to understand compared to disaggregating prior year distributions and aggregating current year distributions, excluding tax return of capital. See SEC Staff Update portion of these meeting highlights for the EP members discussion of this proposed presentation with the SEC staff.

5. The EP discussed example journal entries, financial statement presentation and footnote disclosures relating to the implementation of FASB ASU 2017-08, *Receivables–Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*):

For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities.

An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle as required by ASC 250.

Example Security for a registered fund with a calendar year end (hypothetical amounts for illustrative purposes only)

Par:	$10,000,000
Purchase Date:	01/01/2016
Original Cost:	$12,000,000
Maturity	12/31/2025 (previously amortized to this date – 10 years)
Earliest Call Date	12/31/2022 (now amortized to this date – 7 years)
Beginning of the period of adoption:	01/01/2019
Amortized cost as of 12/31/2018:	$11,400,000
Amortized cost as of 12/31/2018 (post-adoption):	$11,250,000
Amortized cost as of 06/30/2019, the first reporting date following adoption:	$11,220,000
Decrease in amortized cost as of 01/01/2019:	$150,000

Journal Entries (for cumulative-effect adjustment) to be recorded as of the beginning of the period of adoption

DR: Unrealized (Asset account)	150,000	
CR: Cost (Asset account)	150,000	
DR: Distributable Earnings (Equity account)		150,000
CR: Unrealized App/Dep (Equity account)		150,000

Impact to financial statement line items for this one security position (as an example)

NOTE: *Due to the SEC Disclosure Update and Simplification rule, the components of distributable earnings will no longer be shown on the statement of assets and liabilities.*

Statement of Assets and Liabilities as of June 30, 2019

Investments, at fair value (cost $11,220,000) $13,000,000

NOTE: Cost as of the beginning of the period of adoption will be reduced for the cumulative-effect adjustment. No additional disclosure on the face of the Statement of Assets and Liabilities is required. The Notes to the Financial Statements will disclose the impact of the new accounting pronouncement. The cost basis on the initial statement of assets and liabilities following adoption is lower than cost immediately following adoption due to additional amortization from the beginning of the period of adoption through the reporting date.

Statement of Operations

NOTE: Due to the cumulative-effect adjustment as of the beginning of the period of adoption, a user will need to consider the amount disclosed in the Notes to the Financial Statements in order to be able to roll unrealized appreciation/depreciation from one period to the next. No additional disclosure on the face of the Statement of Operations is required. The Notes to the Financial Statements will disclose the impact of the new accounting pronouncement.

Notes to Financial Statements:

Newly adopted accounting pronouncement

In March 2017, the Financial Accounting Standards Board issued Accounting Standards Update No. 2017-08 (“ASU 2017-08”), “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities.” ASU 2017-08 changed the amortization period for certain callable debt securities held at a premium. Specifically, it required the premium to be amortized to the earliest call date. The Fund has adopted and applied ASU 2017-08 on a modified retrospective basis through a cumulative-effect adjustment as of the beginning of the period of adoption. As a result of the adoption of ASU 2017-08, as of January 1, 2019, the amortized cost basis of investments was reduced by $150,000 and unrealized appreciation of investments was increased by $150,000. The adoption of ASU 2017-08 had no impact on beginning net assets, the current period results from operations, or any prior period information presented in the financial statements.

NOTE: Additional disclosures will be required if there are indirect effects of a change in accounting principle (e.g. fees or other expenses that are calculated based upon net investment income).

6. The EP was updated on the AICPA efforts regarding applicability of FASB ASC 325-40 to investment companies (trading securities).

III. Audit and Attest Issues:

1. The EP was updated on the AICPA and CAQ efforts regarding referencing periods within the auditors’ report for investment company complexes that include multiple funds which commenced operations on different dates, in light of the new auditor reporting model under the PCAOB standard. The EP is monitoring this effort and will be updated on new developments in the future.
2. The EP members discussed Rule 206(4)-2(a)(6)(ii)(A) of the Custody rule and whether they have seen in practice registered investment advisers (RIAs) obtain an internal control report for periods less than a full year (e.g., nine months ending September of each year). The EP expressed a view that generally, there should be “no gaps” in the coverage contained in internal control reports.
3. The EP discussed sampling considerations as it relates to testing zero and closed accounts for surprise examinations, specifically, whether the SEC staff would expect a separate sample for zero and closed accounts or if these accounts can be incorporated into one population. The EP noted that such determination should be based on relevant attestation standards.

IV. SEC Staff Update:

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 comments and observations 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.

1. The SEC’s Division of Investment Management Chief Accountant introduced two new Professional Accounting Fellows in its Chief Accountant’s Office.
2. The SEC staff highlighted the following matters for registered investment companies (RICs) and business development companies (BDCs) as a result of the SEC Disclosure Update and Simplification Release which was adopted on August 17, 2018. The amendments revise or eliminate certain disclosure requirements that have become redundant, duplicative, overlapping, outdated, or superseded:
    a. Distributable Earnings for Registered Investment Companies:

- Statement of Assets and Liabilities
    - Rule 6-04.17 of Regulation S-X has been amended to require presentation of the total, rather than the components, of distributable earnings on the balance sheet.
- Statement of Changes in Net Assets (SOC)
    - Rule 6-09.7 of Regulation S-X has been amended to delete the requirement for parenthetical disclosure of undistributed net investment income on the statement of changes in net assets on a book basis.
    - Rule 6-09.3 of Regulation S-X has been amended to require presentation of distributions to shareholders in total, except for tax return of capital distributions, which should be disclosed separately.

  UPDATE: Subsequent to the September 2018 EP meeting, the SEC staff discussed with certain EP members that the above amendments to Regulation S-X requirements to show distributions to shareholders in total does not eliminate the requirement in ASC 946-205-45-4a, which states that for multiple class funds, dividends and distributions paid to shareholders for each class are required to be presented on the statement of changes in net assets or disclosed in the notes to financial statements.

- Financial Highlights
    - The SEC staff received comments on the proposed rule indicating that the per share distribution disclosure on the financial highlights is meaningful to investors and should not be changed to conform to the presentation on the SOC. Accordingly, no changes were made to the financial highlights; registrants should follow relevant instructions from Form N-1A or Form N-2.
- Disclosure
    - The SEC staff additionally noted that the changes above do not impact the U.S. GAAP requirements for tax basis disclosures in the footnotes, so registrants should continue to include those disclosures in the financial statements.

b. Consolidation

- The SEC staff noted that the final rule also updated Rule 6-03(c)(1)(i) of Regulation S-X, in order to align with U.S. GAAP, to remove the rule which allowed for consolidation of the financial statements of RICs and BDCs only with the financial statements of subsidiaries which are investment companies themselves. The SEC staff reminded entities that this update also aligns with guidance in the Guide and with Investment Management Guidance Update No. 2014-11, *Investment Company Consolidation*.

c. BDC Specific Changes

- Reconciliation of Changes in Stockholder's Equity:
    - The SEC staff noted that the final rule amends interim financial statement requirements and will now require a reconciliation of changes in stockholders' equity in the notes or as a separate statement, which will impact BDCs. This analysis should reconcile the beginning balance to the ending balance of each caption in stockholders' equity for each period for which an income statement is required to be filed and comply with the remaining content requirements of Rule 3-04 of Regulation S-X. As a result, registrants will have to provide the reconciliation for both the year-to-date and quarterly periods and comparable periods in Form 10-Q but only for the year-to-date periods in registration statements.

  Update: Subsequent to the September 2018 EP meeting, the Division of Corporation Finance issued a FAQ which addresses the effective date for the above requirement for interim financial statements. Refer to Disclosure Guidance from the Division of Corporation Finance of the Securities and Exchange Commission, Compliance and Disclosure Interpretations Section 105: Form 10-Q, new Question 105.09, issued September 25, 2018. This effective date guidance only applies to the above requirement for interim financial statements and does not apply to any Article 6 amendments.

d. Amendments to Regulation S-K:

- Sale and Bid Prices:

- The final rule eliminated the requirement in Item 201(a)(1) for detailed disclosure of sale or bid prices for most issuers whose equity is traded in an established public trading market and replaced it with disclosure of the trading symbol.
- As described in footnote 410 of the final rule, "Form N-2, which is used for registration of closed-end management investment companies, includes disclosure requirements relating to sales prices and bid information that are similar to those in Item 201(a)(1) of Regulation S-K. Item 1, Instruction 1 and Item 8.5(b) of Form N-2. In addition to these requirements, Form N-2 requires disclosure of information relating to net asset value and discount or premium to net asset value. Item 8.5(b), Instructions 4 and 5 and Item 8.5(c) through (e) of Form N-2. Disclosure of sales prices and bid information is needed in registration statements on Form N-2 so that the required premium/discount disclosure can be fully understood. Accordingly, the Commission did not propose to change the requirements in Form N-2 relating to sales prices and bid information."

e. Historical Presentation:

- The SEC staff noted that technically, the historical presentation of statement of changes in net assets (SOC) with respect to the distribution amounts paid to shareholders should remain consistent with the prior year. However, the EP inquired of the SEC staff's view on the implementation matters discussed above in the EP section of the minutes with respect to presentation of prior year distribution amounts on the SOC. The staff did not object to the EP's view and therefore would not object if investment companies conform the presentation of the prior year's distribution amounts on the SOC to the current year's presentation on the SOC, as long as they include a footnote on the SOC indicating the reason for the changing the prior year's presentation and disclose the disaggregated distribution amounts from the prior year, so that the investors would still have the information available on the SOC. The staff also did not object to including the prior year's undistributed net investment income in the footnote.

f. Effective Date:

- The EP and the SEC staff discussed the effective date of the Regulation S-X amendments.
- **Update**: Subsequent to the September 2018 EP meeting, the final rule was published in the Federal Register on October 4, 2018 and is effective November 5, 2018. The amendments to Regulation S-X are effective for reports filed on or after the effective date.

3. The SEC staff shared that Form 12b-25 "Notification for Late Filing" has not been updated for the RIC Modernization rule, which rescinded Form N-SAR. Consequently, Form 12b-25 does not include a checkbox for Form N-CEN (only N-SAR). Registrants should continue (for now) checking box "N-SAR" for late filings until Form 12b-25 is updated.

4. Change in auditor – the SEC staff reminded registrants that registrants should be including the predecessor auditor's consent in their registration statement filings the first year a registration statement is filed after the change in auditors. Recently, the staff has observed that many registrants are not including the predecessor auditor's consent in the first registration statement filing. The staff reaffirmed that their position, originally stated in the July 2005 EP minutes, has not changed. Registration statement filings should either contain or incorporate by reference the audit reports of a predecessor auditor for at least as long as financial statements audited by the predecessor firm are included in the annual report. Practically speaking, because the statement of changes includes two years, as long as the statement of changes audited by the predecessor firm is included in the annual report being included in the filing, the predecessor auditor's report and consent should be incorporated/included in the filing.

5. The SEC staff covered certain relevant points from recent Statement Regarding Staff Views by Chairman Clayton, including that "all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties" and among other SEC divisions and office, the Division of Investment Management "will continue to review whether prior staff statements and staff documents should be modified, rescinded or supplemented in light of market or other developments".

6. The SEC staff is evaluating comments received on the SEC proposed Rule "Auditor Independence with Respect to Certain Loans of Debtor-Creditor Relationships".

7. Section 19(a) of the Investment Company Act of 1940 ("1940 Act") generally prohibits management investment companies from making a distribution from any source other than the fund's net investment income, unless that payment is accompanied by a written statement that adequately discloses the source or sources of the payment. The SEC staff reminded entities that IRS Forms, specifically IRS Form 1099, would not satisfy the requirement under Rule 19a-1 for a written statement to accompany dividend payments due to the timing of the notification, as a Section 19(a) notice should be sent contemporaneously with the distribution. Additionally, as Form 1099 is designed with the IRS tax regulations in mind, it may not contemplate the notification requirements included in Section 19(a). The SEC staff also stated that they have previously communicated that the Section 19(a) rules are based on "good accounting practice." The SEC staff's view is that this means accounting based on U.S. GAAP, but its prime focus is on egregious violations of the rule. The SEC staff would not object if either U.S. GAAP or tax basis is used, as long as the basis is applied consistently. This is consistent with views expressed historically by the staff and stated within the April 17, 2008 EP minutes.

8. In his Remarks before AICPA National Conference on Banks & Saving Institutions, Chief Accountant Wesley Bricker covered, among other topics:

a. Digital assets:

- a reminder to understand the technology used and utilized, and act appropriately within existing laws and regulations as they relate to books and records, internal accounting control, internal controls over financial reporting, and custody;
- provided five illustrative examples, including those on books and records, fair value measurements and related parties, and audit committee considerations.

b. Implementation of new auditor reporting model and an invitation to registrants, audit committees and auditors to share their experience with the SEC and PCAOB regarding implementation of critical audit matters.

Investment Companies Expert Panel

November 2018 Meeting Highlights

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights:

I. AICPA/Administrative:

1. The Expert Panel (EP) September 2018 meeting highlights are [available].

2. The EP staff noted timing for first review of proposed conforming changes to the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. The EP considered financial statement presentation for partially failing deposit securities. An EP member presented a scenario where an ETF issued creation units in-kind (deposit securities) to an Authorized Participant (AP) in exchange for contributed securities but certain securities were not received by the ETF (classified as failing deposit securities) and cash collateral has been deposited by the Authorized Participant (AP) on behalf of the ETF, but was not yet deployed to cover the failing deposit securities. The EP discussed the financial statement implications of such transactions.

   ETF issuers use creation units for new share issuance through broker-dealers. They also have relationships with broker-dealer trading desks, which act as APs. For creation units in-kind, the AP delivers cash collateral on behalf of the ETF for the deposit securities not yet received (classified as failing deposit securities). If and when the ETF decides to close out the trade and use the collateral to purchase the undelivered deposit securities, the AP will be liable for (1) the costs incurred by the ETF in connection with any such purchases and (2) any shortfall between the cost of the purchased deposit securities and the value of the cash collateral.

   The AP has an obligation to the ETF to fulfill its obligation of funding the creation of the new ETF shares. The ETF has fulfilled its legal obligation by issuing shares to the AP and recognized the shares issued to the AP on its books and records. Lastly, both the ETF and the AP have access to the cash collateral at the custodian; however, the other party must be notified and proper proof of delivery/non-delivery of assets is verified by the custodian prior to cash movement; indicating that neither party has control over the collateral.

   The EP members discussed the financial statement presentation of the deposit securities not yet received. The EP members discussed whether a right to offset exists. Per ASC 210-20-45-1 states,

   > "A right of setoff exists when all of the following conditions are met:
   >
   > a. Each of two parties owes the other determinable amounts.
   > b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
   > c. The reporting party intends to set off.
   > d. The right of setoff is enforceable at law."

   The EP members considered whether the collateral belonged to the ETF or not. The EP members discussed the considerations should be given to whether the contributing party fulfilled its obligation, which would be a legal determination. Generally, the EP members discussed the collateral would not belong to the ETF, until such time the ETF decided to forgo delivery of the shares, which is also a legal determination.

2. The EP continued discussing applicability of FASB ASC 326 (CECL) to investment companies holding beneficial interests within the scope of ASC 325-40 in light of the [November 1, 2018 TRG meeting](). At that meeting, FASB staff noted that financial assets measured at fair value through net income are not in the scope of ASC 326-20. Accordingly, entities would not have an allowance for credit losses for beneficial interests classified as trading within the scope of ASC 325-40. The staff further noted that the entities would need to use reasonable judgement in determining the amount of accretable yield for beneficial interests classified as trading. The EP members generally agreed that both Views A and B discussed on the March 2018 EP conference call contained reasonable judgements.

3. The EP considered several implementation issues related to the adoption of ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement* for nonpublic investment companies:

   a. ASC 820-10-50-2(bbb)(2)(ii) does not require nonpublic entities to provide the information described in (bbb)(2)(i), which requires public entities to disclose the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements; however, nonpublic entities are required to provide quantitative information about the significant unobservable inputs used in the fair value measurement in accordance with (bbb)(2). An EP member expressed the view that the ASU dictates what public companies are required to disclose; however, the ASU offers more flexibility for nonpublicnon-public entities. The EP members discussed how non-public entities could meet the quantitative information requirement about significant unobservable inputs. The EP expressed a view that a nonpublic investment company may meet the quantitative information requirement for significant unobservable inputs by providing the range of such inputs, but unlike a public company, the nonpublic investment company is not explicitly required to provide the weighted average of such inputs. Certain EP members felt that under certain circumstances, nonpublic entities could continue to disclose quantitative information as they historically have disclosed (i.e., range and weighted average of significant unobservable inputs) while in other circumstances, nonpublic entities may only elect to disclose either a range of significant unobservable inputs or the weighted average of significant unobservable inputs. The EP further noted that an entity would need to ensure their quantitative disclosure is still meaningful to investors.

   b. ASC 820-10-50-2G states that in lieu of the Level 3 rollforward, nonpublic entities should disclose separately changes during the period which are attributable to purchases, issues and transfers into/out of Level 3 of the fair value hierarchy. The EP members discussed whether nonpublic entities are required to disclose Level 3 purchases, issues, and transfers by class. The EP members also discussed whether nonpublic entities disclose Level 3 purchases, issues and transfers of derivatives on a gross or net basis.

   The EP members generally expressed a view that nonpublic entities are required to disclose Level 3 purchases, issues, and transfers by class.

4. The EP discussed the recently issued Working Draft of the AICPA Accounting and Valuation Guide *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*. The EP members found the illustrative examples provided in the guide to be helpful for discussions with those in the industry.

5. The EP members considered several implementation questions related to the amendments to Article 6 of Regulation S-X. Please see SEC Staff Update section for more information.

III. Audit and Attest Issues:

1. Form N-CEN requires a registrant to include in their annual Form N-CEN filing the independent accountant's report on internal control. Per Form N-CEN, *"The accountant's report shall be based on the review, study and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities made during the audit of the financial statements for the reporting period. The report should disclose any material weaknesses in: (a) the accounting system; (b) system of internal accounting control; or (c) procedures for safeguarding securities which exist as of the end of the Registrant's fiscal year."*

   The EP members discussed the PCAOB standards used for the report required by Form N-CEN. The EP members noted that the report for the purposes of Form N-CEN is on the company's internal control over financial reporting.

2. Critical audit matters (CAMs) will be applicable to business development companies (BDCs). The EP discussed implementation matters related to CAMs and will continue discussing this topic as needed.

3. Upon liquidation of pooled investment vehicles, Rule 206(4)-2(b)(4)(iii) requires a registered investment adviser to distribute audited GAAP financial statements to limited partners (or members or other beneficial owners) promptly after the completion of such audit. The EP members discussed a scenario where the fund was liquidated by selling the partners' interest rather than the underlying investments of the fund. The EP members agreed that ultimately this is a legal determination and entities should confer with their legal counsel and or chief compliance officer.

4. The EP considered modifications to the illustrative independent accountant's report, which is issued on the annual study and evaluation of a transfer agent's internal controls, as required to be filed with the SEC pursuant to Rule 17Ad-13 of the 1934 Act (par. 12.47 of the 2018 Guide).

   The EP members will continue discussing proposed modifications to the report at the following meeting.

IV. SEC Staff Update:

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1. Policy update:

   a. The SEC Office of Information and Regulatory Affairs and the Office of Management and Budget issue a semi-annual comprehensive list of rulemakings the SEC staff is working on. The Fall 2018 Agency Rule List includes, among others, offering reform for BDCs, auditor independence with respect to loans or debtor-creditor relationships, exchange-traded funds, modernization of investment company reporting disclosure, and use of derivatives by registered investment companies and business development companies.

   b. The SEC staff is considering recommendations for updating the Commission's existing valuation guidance for management and Boards of registered investment companies to reflect the evolving markets and existing accounting and auditing standards.

   c. The SEC staff also mentioned that amendments to the Custody Rule for Investment Companies and Investment Advisers are on the SEC's long-term agenda.

   d. The SEC staff informed the EP about the recently launched Strategic Hub for Innovation and Financial Technology (FinHub). It will serve as a resource on any of the SEC's FinTech-related issues and initiatives, including digital assets, distributed ledger technology, artificial intelligence and machine learning, among others, and also as a portal to the industry, where constituents can submit inquiries.

2. The SEC amended Regulation S-X through the adoption of its Disclosure Update and Simplification final rule. See the September 2018 EP minutes for the impact of the amendments to regulated investment companies as well as the SEC staff's views on conforming historical presentation to the current year's presentation for the comparative statement of changes in net assets.

   The SEC staff commented on the following implementation questions related to the amendments to Article 6 of Regulation S-X presented by EP members:

   a. Is it acceptable to not disclose the GAAP character of prior year distributions on the statement of changes in net assets or in the notes to the financial statements? The tax character of prior year distributions are disclosed in the notes to the financial statements.

   b. Is it acceptable to not disclose the prior year GAAP-basis undistributed net investment income on the statement of changes in net assets?

   Staff View: With respect to questions (a) and (b), the SEC staff did not express a view but noted that the rule amends Regulation S-X prospectively and does not require retrospective application. The prior year financial statements were completed under the pre-existing rules and if a fund is going to change historical presentation in future reports, the staff recommends registrants consult with their auditor.

   c. For comparative balance sheets of a BDC, is it acceptable to collapse prior year components of equity to conform to current year Regulation S-X requirements and footnote the amount to explain why the presentation changed and disclose the prior year amounts in a footnote to the balance sheet? Such presentation would be consistent with what was discussed in September 2018 SEC Staff Update for statement of changes in net assets.

   Staff View: The SEC staff would not object if a BDC conforms the presentation of the prior year's components of equity on the SAL to the current year's presentation on the SAL, as long as they include a footnote on the SAL indicating the reason for the change in presentation and the amounts, so that the investors would still have the information available on the SAL. The staff would also not object if the historical presentation remained the same and was inconsistent with the current year presentation.

   d. How should distributions be presented in the financial highlights per share section now that net investment income (NII) and realized distributions are combined on the statement of changes in net assets? Form N-1A/N-2 instructions say that distributions from NII, net capital gains and return of capital should all be stated separately.

   However, ASC 946-205-50-7(e) states that "Distributions to shareholders shall be disclosed as a single line item except that tax return of capital distributions shall be disclosed separately. Details of distributions shall conform to those shown in the statement of changes in net assets." How should registrants interpret these seemingly contradictory requirements?

   Staff View: The SEC staff does not believe the requirements are in conflict with one another, but rather views the Form N-1A/N-2 requirements as incremental to those required by GAAP. As the financial highlight requirements in the Forms have not changed, the SEC staff would not expect to see a change in a registrant's presentation of its financial highlights.

3. The SEC staff shared recently issued no-action letters[1] providing relief to issuers of certain non-variable insurance products under Regulation S-X §3-13 to file its audited financial statements prepared in accordance with statutory accounting principles in place of financial statements prepared in accordance with U.S. generally accepted accounting principles in registration statements submitted under the Securities Act of 1933 on Form S-1 for certain insurance contracts.

4. The SEC staff would like to remind registrants to be cognizant of the form questions and requirements in completing their Form N-CEN filings. The SEC staff has observed responses to form N-CEN that may contain errors such as (1) certain ETF registrants answering that they don't rely on exemptive orders; (2) certain registrants reporting that they have no investment adviser; (3) certain registrants indicating that they are not utilizing any pricing services (which may be an appropriate response in some circumstances). IM's Analytics Office and OCIE, if appropriate, may contact registrants in connection with these or other errors identified in those filings to date.

5. Subsequent to the November EP meeting, on November 14, 2018, the Division of Investment Management updated Investment Company Reporting Modernization Frequently Asked Questions (FAQs). Included in the updated FAQs are staff responses to questions concerning Compliance Dates and General Filing Obligations, Form N-Port, Regulation S-X (including requirements associated with custom basket disclosures), and Form N-CEN.

[1] Allianz Life Insurance Company of North America, September 28, 2018
Athene Annuity and Life Company, September 28, 2018
Great West Life & Annuity Insurance Company, September 28, 2018
Midland National Life Insurance Company, September 28, 2018