## Asset Management Intelligence

A publication from The Financial Services Group

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Getting Ready for the New Partnership Audit Regime

By Kayla Konovitch

The Tax Equity and Fiscal Responsibility Act ("TEFRA") partnership audit rules and Electing Large Partnership Rules are being replaced by a new audit regime adopted in the Bipartisan Budget Act of 2015 ("BBA"). The BBA dramatically changes the partnership audit rules from a regime that passed through the partnership adjustments to collect tax, penalties, and interest from the partners, to a regime that allows for collection directly from the partnership. Congress is making these changes in response to concerns that the IRS was unable to effectively and efficiently audit partnerships due to cumbersome rules and procedures (and as a result, partnerships weren’t being audited). The intent of the BBA is to streamline partnership audits so that a final decision is binding on the partnership and partners and to reduce the burden of the government.

The new partnership audit rules are generally effective for tax years beginning after December 31, 2017. There is an early adoption provision if a partnership makes an election to apply the new rules to returns filed for tax years beginning after November 2, 2015.

Although partnership audit rules are effective beginning in 2018, with returns filed in 2019, the new audit procedures are unlikely to be put into practice before 2020.

PARTNERSHIP REPRESENTATIVE

The BBA has done away with the TEFRA “tax matters partner” ("TMP") designation. Instead, there will be a “partnership representative.” The partnership representative has broad power to make important decisions and elections for the partnership under audit, and so it is important that the partnership agreement address those powers.

OVERVIEW OF THE NEW AUDIT APPROACH

If the IRS adjusts items on a partnership, any tax, penalties, and additions to tax will be determined, assessed, and collected at the partnership level. The partnership pays any imputed underpayment with respect to the reviewed year. The “imputed underpayment” is the net of all partnership adjustments for the reviewed year multiplied by the highest individual or corporate tax rate.

Under these rules, the burden of the tax liability due to IRS adjustments will be borne by persons who are partners in the partnership during the year the adjustment is made, rather than the year the income that resulted in the tax liability was earned. Therefore, persons acquiring an interest in a partnership should be aware of possible understatements by the partnership in earlier years.

There are 3 options to either bypass or modify the partnership imputed underpayment. The first procedure is for a partnership to request a modification to the IRS partnership adjustments. The modification rules will serve to more closely reflect the tax that would have been due by the partners had the partnership and partners correctly reported and paid in the tax. The second option is to elect out of the new audit rules for certain partnerships with 100 or fewer partners that meet the requirements. Alternatively, a partnership can make the so-called “push-out” election. This election allows the partnership to shift the liability for the imputed underpayment to the partners who were partners during the year under audit.

The push-out election can be useful in vehicles, such as hedge funds, where there may be significant changes in the number and identity of partners from year-to-year.

PROPOSED TECHNICAL CORRECTIONS

Technical corrections related to the partnership audit rules were proposed in 2016. The corrections were intended to make fundamental changes and to clarify terms and processes so as to improve enforcement by making the audit of partnerships easier to administer. The Tax Technical Corrections Act of 2016 was not adopted; however, its provisions are likely to be the starting point for any changes in the partnership audit rules that are incorporated in tax legislation in 2017.

Key elements that the technical corrections are attempting to modify are to: expand the scope of statute to “partnership-related items;” provide clarification that entity level tax is computed without netting, where netting is inappropriate in determining the imputed underpayment; add additional requirements in making the push-out election and clarify that push-out applies in tiered arrangements; include a new “pull-in” procedure that allows partners to be pulled into a partnership audit; and provide regulatory authority to prescribe guidance under which the partnership audit rules do not apply and provide for special rules to apply to certain special enforcement matters.

PROPOSED REGULATIONS

On January 18, 2017, the IRS issued proposed regulations on implementation of the rules for partnerships subject to
the new audit regime. However, the proposed regulations were withdrawn pending review by the new administration as a result of President Trump’s executive order initiating a moratorium on all federal rulemaking.

WHAT PARTNERSHIPS AND PARTNERS NEED TO CONSIDER

Given the impact of the new audit rules, many partnership agreements and operating agreements will need to be amended. Now is the time to consider any necessary changes. The following issues should be considered and discussed with a tax advisor:

- **Partnership Representative** – What procedures should be put into place for selecting a partnership representative? Who should be the partnership representative? What are the representative’s specific duties? Can the operating agreement limit the partnership representative’s authority? Should the partnership representative be obligated to notify all of the partners of the audit? Can limited partners participate in the audit process? Can the operating agreement require cooperation among all the partners to reduce the imputed underpayment calculation? Although the partnership representative clearly binds the partnership, the partners can still remove the partnership representative.

- **Partnership Elections** – Should the partnership include a provision for early adoption of the rules? Should the operating/partnership agreement contain a mandatory election out? If the partnership opts out, TEFRA rules will not apply either. Instead, the partnership will be subject to pre-TEFRA process of the IRS asserting deficiencies against individual partners either following a partnership exam or as part of an individual exam; does the partnership want that? Will these partnerships that opt-out then become low priority for IRS examinations? Should the partnership include a provision for the “push-out” election? Is the partnership eligible to make certain partnership elections?

- **Eligibility to Opt Out** – Should the partnership agreement or subscription documents contain provisions that partners cannot transfer interest to impermissible partners or partners that would cause the total K-1s to exceed 100?

- **New Partners** – New partners should consider any potential tax obligations for prior years. Should a new partner who did not own an interest in the partnership in a reviewed year be liable for tax paid by the partnership? Should the partnership agreement prohibit transfers of partnership interests to persons who would terminate? Should partners request side letters to ensure partnerships make the opt-out election or the push-out election?

- **Payment of Tax and Expenses** – If the partnership pays tax assessed, how should the partnership collect from former partners that were partners in the year reviewed but are no longer partners in the year the tax is paid? Should the current partners bear the financial burden? Should the partnership agreement contain a provision for partner indemnification of partnership payments? How should the expenses of dealing with the audit be treated? How will tax payments made by the partnership be processed and collected?

- **General Partner Issues** – Will the partnership tax hit the incentive fee? Should this be worked into the partnership agreement so that there will be no impact to the incentive fee? Should the GP convert to an S corporation structure so the fund can be eligible for the opt-out election?

- **Structure** – What is the best way for funds to be structured in light of the new partnership audit rules? Will the rules have an impact on whether a master feeder structure or mini-master feeder structure should be used due to likelihood of being audited?

- **Provision for Income Taxes** – What consideration should be given as to whether a provision for income taxes should be booked on the financial statements due to a possible imputed underpayment of income tax of the partnership? This may be an important issue if the partnerships issue financial statements that conform to U.S. GAAP. Additionally, will the new rules have an impact on tax return positions taken by funds due to increased audit risk and potential partnership level tax liabilities?

- **Tax Benefits of the Partnership Level Tax** – How does this impact the net investment income tax (“NIIT”) and self-employment tax (“SE”)? The applicable tax rate at the partnership level does not factor in the NIIT or SE tax,
so these taxes may be avoided.

- **Business Issues** – Where is management responsibility placed? Is responsibility placed with new partners or former partners? There are competing interests here. If the push-out election is made, will new partners be motivated to contest proposed changes on behalf of former partners? The new partners may not want to spend time or resources on contesting the changes. Will the former partners be represented in the audit?

**ACTION STEPS**

1. Fund and operating agreements will need to be updated. Instead of a TMP, a partnership representative will need to be designated.

2. Discussions should be taking place in regard to partnership representative duties and management responsibilities, which elections should be made, procedures and terms for entry of new partners and exit of former partners.

3. Offering memorandums should be updated to disclose the new rules and their effect, including that the partnership, and current partners, could potentially be liable for taxes that relate to prior years.

4. Partnership agreements may need to include indemnification provisions for taxes paid and set forth tax sharing provisions describing how taxes or adjustments are allocated among partners. The agreement should also include provisions of how the incentive fee is calculated considering the partnership tax.

5. For funds of funds, discussion should take place with regard to requests they may want to make in side letters for investments.

**CONCLUSION**

The new partnership audit rules will bring drastic changes to partnerships impacting operations, tax issues, related legal matters, and economic concerns. This synopsis is provided as a brief summary of some of the new partnership audit rules. Keep in mind there are many unanswered questions as well as confusing and overlapping choices, with further technical corrections and final regulations still to come.

MLPs, hedge funds, private equity firms, real estate entities and all businesses structured as a partnership or LLC should be proactive in addressing these issues given the magnitude of the new partnership audit rules.

All parties need to sit down and negotiate; there are no grandfather rules. If you are a partner or manager in a partnership now and are not willing or cannot exit or terminate; you are at risk. These rules are of concern now. Deal with the issues in abstract form before they are in actual dispute or controversy. There is still time before the rules are effective. Act now.

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To Seed or Not to Seed

By Jason Grunfeld, Partner, Kleinberg, Kaplan, Wolff & Cohen

It is one of the age-old quandaries in the fund industry: Try and obtain a seed deal or forego that option and try to make a go of it on your own. In today’s ever-changing world, raising capital has become increasingly challenging for start-up fund managers. However, there are now more alternatives than there have been in the past.

For those unable to secure a seed deal, or who are not interested in giving up a substantial portion of their management company and general partner: Do not fear, you now have another tool in your belt to attract Day 1 capital. The introduction of the concept of founders’ class shares/interests in the last 2-3 years has given fund managers who do not proceed with seeders a better chance of raising Day 1 capital.

The concept behind a founders’ class is that the manager will typically offer discounted fees to investors that meet certain criteria, sometimes in exchange for a longer lock-up, and sometimes just because they were early investors in the fund. The criteria may focus on the size of investment, but often also includes a certain time period or threshold assets under management (AUM). For example, a fund may offer founders’ class terms to any investor that invests over $1 million so long as that investment is made before the earlier of 6 months from launch or the time that the fund has $50 million in assets. The beauty of the founders’ class concept is that it is a pure business decision made by the manager. They can determine the size of the check, the time-frame or the AUM threshold in question, which determine eligibility for the founders’ class all based on what makes sense for their business. It can also be any one of those 3 criteria or a combination of the 3.

Since the introduction of the founders’ class, most funds have this option built into their offerings and it is now pretty standard. This can be done whether or not the manager is entering into some sort of seed arrangement, so entering into a seed deal does not preclude a manager from offering a founders’ class as well.

For managers looking to enter into some sort of seed arrangement, the landscape has changed over the past several years. No longer are managers dependent on chasing the “white whale,” those large seeders that write 9-figure checks. Those seed deals are few and far between. The number of large seeders has decreased over time and those that remain typically only write 2-3 checks a year, so the chances of getting that deal are very slim.

However, a whole new crop of participants have joined the seeding world and they come in all shapes and sizes. We have seen everything from family offices to high net worth individuals seeding managers. Sometimes, a manager will get some sort of seed capital from their prior employer. There are also seeders that will give them capital, but they require it to be in a managed account structure, not a fund. A major issue to consider when taking seed capital is how long that investment will be locked up for. As a manager, you would typically want to lock that money up for 2-4 years. Without a significant lock-up, it is probably not worth giving up ownership in your management company and General Partner for a Day 1 investment.

A change we have seen recently in the seeding world is that some managers are not looking for investments in their fund, but rather working capital to be invested in the management company. For a manager, this can help ensure stability on Day 1, make sure the lights stay on for several years so they can hire the right people, build the right systems, etc., which are all imperative to making sure the firm is built to succeed and that it can pass institutional due diligence. This working capital can come in the form of a passive investment or from investors who will actually be involved in helping the manager run the business.

Another factor to consider when thinking about a seed arrangement is what else that seeder might provide. Many will just provide capital (either as an investment in the fund or working capital to the manager), but others will provide support in the form of marketing and capital introduction services as well as infrastructure and back-office assistance.

So, although raising capital has been extremely difficult in the last several years, there are now more options available to a start-up manager, whether they choose to look for a seed deal from a large seeder or one of the alternatives to trying to raise capital through a founders’ class. However, the question remains and will continue to be debated: to seed or not to seed...

Jason Grunfeld is a partner in the hedge fund group at Kleinberg Kaplan and is also the head of business development for the firm. Jason advises private investment funds and registered and unregistered investment advisers on regulatory and strategic issues related to their formation, structure and operation as well as structures agreements among the principals of management companies. Jason also drafts and negotiates seed deals and strategic investments in addition to side letters. Questions? Jason can be reached at 212.880.9887 or jgrunfeld@kkwc.com.
What U.S. Fund Managers Need To Know When Setting Up an Irish Fund Structure

By David Carroll

Ireland is widely regarded as one of the key strategic locations by the world’s leading players within the funds industry and 2016 proved to be another successful year for the country. Ireland’s track record as a regulated and internationally recognised jurisdiction, along with its wealth of professionals with expertise and experience in retail and alternative investments, offers a compelling set of advantages for U.S. fund managers considering where to domicile an Undertakings for Collective Investments in Transferable Securities (“UCITS”) fund or an alternative investment fund (“AIF”). This article aims to provide U.S. fund managers with practical information on why Ireland should be considered when choosing a location for their funds, the regulations that apply to various fund structures within the country and how to set up a fund there.

WHY IRELAND

Ireland is a significant centre for international banking, funds and insurance. The country’s international financial services sector has witnessed dramatic growth and phenomenal success since its launch over 30 years ago.

Post-Brexit, Ireland will be the only English-speaking member of the European Union with the euro as its currency. In addition, Ireland is an internationally recognized open and tax-efficient jurisdiction and has the lowest headline corporate tax rate in the Organization for Economic Co-operation and Development (“OECD”). With a 12.5% corporate tax and no taxes on funds or investors, Ireland has a favourable tax environment that ensures the best outcome for the fund and the investor.

Ireland offers managers access to the EU-wide marketing passport for UCITS and AIFs. Currently 18 of the top 20 global asset managers have their funds domiciled in Ireland and over 800 fund managers from 50+ countries have their assets administered in Ireland.¹

In a recent survey conducted by Economist Intelligence Unit, over 200 asset managers were asked their views on the leading European investment fund domiciles and the most important factors which guide a domicile decision. The 3 jurisdictions which performed best overall in the survey were Ireland, Germany and Luxembourg. Ireland received the combined overall highest number of preferences across each of the categories surveyed with 71% of global asset managers indicating that, if starting over, they would choose Ireland as one of their top 3 European fund domiciles.²

EUROPEAN INVESTMENT FUNDS -- UCITS OR AIF?

European investment funds are either regulated as UCITS funds under the UCITS directive or as non-UCITS or, as they are now more widely known, AIFs under the Alternative Investment Fund Managers Directive (“AIFMD”).

The first step for any U.S.-based investment manager that is considering establishing a fund in Ireland is to determine whether the fund will fall into the UCITS or AIF category. To do this, it is necessary to consider the activities of the fund, its scale, its investors or shareholders, and its goals or investment policies.

UCITS FUND CONSIDERATIONS

General restrictions regarding eligible investments - Investments in transferable securities, for example equities and bonds, must have good liquidity and must, in general, be traded on a regulated market. If a security is not traded on a regulated market, then the fund must give consideration to its liquidity and assess its negotiability. In general, a UCITS will not be permitted to invest in any closed-end funds unless the closed-end fund meets certain corporate governance and regulatory requirements.

Investments in financial derivatives are permitted subject to several conditions. The risk profile of the derivatives must not diverge from the UCITS investment objectives.
A UCITS may invest in a financial index subject to several conditions regarding its components, calculation, valuation and publication. Due diligence must also be performed by the UCITS.

UCITS 10/5/40 rule stipulates that no more that 10% of the net assets of the fund may be invested in instruments of any one issuer. Also, 40% of the net assets must not contain exposure exceeding 5% to individual issuers.

Distribution - Over 75% of the assets of Irish domiciled funds are held in UCITS. Irish UCITS are distributed in over 70 countries worldwide.

Source: Lipper IM April 2015 *New to the Top 25

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AIF CONSIDERATIONS

If you wish to set up a fund with a greater risk appetite, a wider range of possible investments and greater access to borrowings, then the appropriate structure is the AIF. The AIF benefits from many of the same regulatory ones as a UCITS such as investor confidence, custodial safekeeping and oversight. However, as AIFs tend to be aimed at professional investors, the AIF allows for a far wider range of investments, derivatives and strategies. Over 40% of global hedge fund assets are serviced in Ireland, making it the largest hedge fund administration centre in the world.

Investment managers wishing to market and distribute alternative investment funds in Europe must now consider the implications of the AIFMD on the distribution of their funds in Europe. All AIFMs located in the EU whether they manage EU or Non-EU AIFs are subject to the AIFMD. AIFMD also captures marketing within the EU of AIFs managed by an AIFM located outside the EU.

Distribution - There are two ways to sell AIFs to European investors:

1. A fund promoter can use the “AIFMD passport” if the promoter has an AIFM based in an EEA member state with a European-domiciled AIF or alternatively the fund promoter establishes an EEA-domiciled self-managed AIF (which is authorised both as the fund and the AIFM). Since mid-2015, the European Commission has been evaluating the possibility of allowing the use of the marketing passport for non-EEA AIFs.

2. Non-EEA managers with structures (see below) may continue to be distributed in various European countries using National Private Placement Rules (“NPPRs”) for as long as they remain available for use. However, these NPPRs are constantly evolving across territories and are due to be assessed by the European Commission between the end of 2017 and July 2018.

LEGAL STRUCTURES FOR IRISH FUNDS

Numerous legal structures are available for both UCITS and AIF funds. The choice of legal structure will depend on the fund preferences, market requirements and operational considerations.

The legal structures available include unit trust, investment company, investment limited partnership, common contractual fund and the Irish collective asset management vehicle (the “ICAV”). These existing legal structures are established under Irish Law and as such are subject to its provisions.

IRELAND’S IRISH COLLECTIVE ASSET MANAGEMENT VEHICLE LEGISLATION PRESENTS NEW OPPORTUNITIES FOR FUND MANAGERS

The introduction of the ICAV legislation that was introduced in March 2015 increases the range of fund vehicles in Ireland available to promoters.

The ICAV is a new corporate vehicle designed for Irish investment funds. It sits alongside the public limited company (“plc”), which has been the most successful and popular of the existing Irish collective investment fund vehicles to date. An ICAV can be incorporated with the Central Bank of Ireland and provides a tailor-made corporate fund vehicle for both UCITS and alternative investment funds.

• Meeting the needs of the asset management Industry

The ICAV is not a company under the Irish Companies Acts, but rather a corporate entity with its own facilitative legislation that has been drafted specifically with the needs of collective investment schemes in mind. This should result in lower administrative costs for an ICAV. In addition, an ICAV can also select the regulatory
regime to apply and can be structured as a UCITS or an AIF. The governing requirements for the preparation of financial statements for an ICAV follow the requirements for UCITS and AIFs. The ICAV also offers flexibility in terms of which accounting standards can be used in the preparation of financial statements, including U.S., IFRS, Japanese and Canadian.

- “Check the box”
  The ICAV is able to elect its classification under the U.S. check-the-box taxation rules and as a result can be treated as a partnership for U.S. tax purposes. This avoids the adverse tax consequences for U.S. taxable investors which arise where the structure is deemed to be a passive foreign investment company ("PFIC") for U.S. federal income tax purposes. The ICAV thereby enhances the attractiveness of Irish funds to investment managers seeking to market their funds in the U.S.

- Re-domiciliation of offshore funds to Ireland
  Given the ICAV’s ability to “check the box” for U.S. tax purposes, there is an opportunity for existing offshore funds to re-domicile to Ireland and continue to maintain favourable tax treatment for their U.S. taxable investors. Irish legislation provides for the efficient and effective re-domiciliation of funds to Ireland. It allows offshore corporate funds from certain prescribed jurisdictions to migrate to Ireland by re-registering as an Irish UCITS or AIF authorised by the Central Bank of Ireland while maintaining its legal identity. Funds from the following jurisdictions can re-domicile to Ireland in an efficient manner: the British Virgin Islands, the Cayman Islands, Jersey, Guernsey, Bermuda and the Isle of Man.

CONCLUSION
To set up a fund in Ireland you must obtain authorisation from the Central Bank of Ireland (the “CBI”). As outlined above, there are a number of steps involved for your funds that include the following:

- **Choose a fund structure** - There are two main fund regimes in Ireland: UCITS and AIFs. There are a number of factors to consider when making this decision including the location of target investors and the investment policy of the fund;

- **Choose a legal structure** - The following legal structures are available in Ireland: ICAV, investment company, unit trust, common contractual fund (“CCF”) and investment limited partnership;

- **Required service providers** - The CBI is the authority responsible for the authorisation of funds in Ireland. They will approve all the below mentioned service providers.

For all Irish funds, a number of service providers must be approved in advance including:
- Legal firm;
- An Irish-based depository;
- An Irish-regulated external auditor;
- An Irish-based administrator (central administration);
- A management company (Unit Trust and CCF);
  and
- Two Irish resident non-executive directors.

In the case of a UCITS, the fund promoter and the investment manager (only if different to the promoter) must also be approved by the CBI. For AIFs, the investment manager must obtain approval as an AIFM from the CBI.

- **Fund approval** - Once the promoter/investment manager have been approved, the final step is obtaining approval for the fund documentation.

**SOURCES:**
1. Irish Funds, December 2015.
2. Economist Intelligence Unit Survey on Choosing a European Fund Domicile, 2014.

*David Carroll is a Manager with EisnerAmper Dublin. Questions? David can be reached at +353.1. 293.3431 or david.carroll@eisneramper.ie.*
A Brief Summary of the Recent AICPA Technical Questions and Answers Applicable to Investment Companies

By Ari Samuel and Sheila Handler

In October 2016, the AICPA issued technical questions and answers (“TQA”) to 8 practice matters related to liquidation basis of accounting and one on the effects of loan origination activity in determining investment company status of an entity. The full TQA can be accessed by clicking the titles below.

**TIS SECTION 6910.36:**
“Determining whether loan organization is a substantive activity when assessing whether an entity is an investment company”

This TQA discusses the considerations of an entity in determining whether loan origination activity represents a substantive business activity that precludes it from qualifying as an investment company under ASC 946-10-15-6. An evaluation of loan origination activities should include a quantitative and qualitative assessment of the significance of those activities relative to the entity’s investing activities. Fee income generated as part of loan origination activities relative to total income is an important factor to be considered. Other qualitative factors to consider include investing activities, regulatory considerations, entity ownership and management, customization of loans, and loan retention by the entity.

**TIS SECTION 6910.37:**
“Considering the length of time it will take an investment company to liquidate its assets and satisfy its liabilities when determining if liquidation is imminent.”

This TQA discusses if an entity should consider the length of time it will take to liquidate its assets and satisfy its liabilities when determining if liquidation is imminent.

Under ASC 205-30-25-2, liquidation is imminent if either of the following is present:

- A plan of liquidation is approved by an authorized person and the likelihood is remote that the plan will be blocked or that the entity will return from liquidation.
- A plan for liquidation is imposed by other forces and the likelihood is remote that the entity will return from liquidation.

The TQA concludes that liquidation is imminent based on the occurrence of events and does not include a time element and therefore the length of time should not be taken into account when determining if liquidation is imminent.

**TIS SECTION 6910.38:**
“Determining if liquidation is imminent when the only investor in an investment company redeems its interest, and the investment company anticipates selling all of its investments and settling all of its assets and liabilities.”

This TQA discusses whether liquidation is considered imminent in a situation where there is a single investor in an investment company and that investor redeems its interest which results in the investment company anticipating selling all investments and settling all assets and liabilities.

The TQA concludes that it depends on the intent of the investment advisor. If the investment advisor anticipates continuing to operate the investment company using the same or similar strategy, and the lack of investors is anticipated to be temporary, the liquidation basis of accounting may not be appropriate. If management does not intend to continue to solicit new investors or with the same investment strategy, the liquidation basis of accounting may be appropriate.

**TIS SECTION 6910.39:**
“Presentation of stub period information by investment company.”

This TQA discusses if an investment company which has adopted liquidation basis should present information for the stub period (last balance sheet date to the date liquidation becomes imminent).

The TQA concludes that an investment company should consider the requirements of its regulator(s), the needs of the users of the financial statements, and the governing documents when determining the information to present. As the governing documents for many nonpublic investment companies require audited financial statements to be provided to investors, and such financial statements may be used to satisfy regulatory requirements (such as Rule 206(4)-2 under the Investment Advisers Act of 1940 (Custody Rule), regulations of the Commodity Futures Trading Commission,
requirements of the Cayman Islands Monetary Authority, OCC or state regulations for bank collective funds) if the date of adoption of liquidation basis differs from year-end, an investment company would most likely present stub period financial statements up to the adoption date of the liquidation basis.

**TIS SECTION 6910.40:**
“Applying the financial statement reporting requirements in FASB ASC 946-205-45-1 when an investment company presents a stub period.”

This TQA addresses the financial statement presentation when both a stub period (going-concern) and a liquidation basis period are presented in one financial statement. As an example, if an investment company with a December 31 year-end adopts liquidation basis on July 1, a full set of financial statements (including financial highlights) should be presented as of June 30 and for the period January 1 through June 30 (excluding schedule of investments). For the liquidation period from July 1 through December 31, only a statement of net assets in liquidation and a statement of changes in net assets in liquidation are required to be presented. If investments are held as of December 31, the statement of net assets in liquidation should include a schedule of investments. The TQA also discuss the presentation of a cumulative-effect adjustment that would bridge the investment company’s ending equity balance under the going concern basis of accounting, with its opening equity balance under the liquidation basis of accounting.

**TIS SECTION 6910.41:**
“Separation of final-period financial statements between going concern and liquidation periods for certain investment companies that liquidate over a short period of time.”

This TQA discusses if liquidation basis of accounting is required to be applied and if the investment company should separate financial information for the liquidation period from the going concern period when liquidation is expected to occur over a short period of time. Regardless of the time it takes to liquidate, separation of the going concern period and liquidation period is required even if the fund can liquidate investments over a short period of time unless it is determined that the effect of adopting the liquidation basis is immaterial to the financial statements taken as a whole. If the effects of adopting liquidation basis of accounting are determined to be immaterial, the notes to the financial statements generally should include an affirmative statement to that effect.

**TIS SECTION 6910.42:**
“Presenting financial highlights under the liquidation basis of accounting for an investment company.”

This TQA discusses if an investment company should present financial highlights after adopting the liquidation basis of accounting. In making that determination, a reporting entity should consider whether and how the accrual of costs and income and recognition of other assets that were recorded as of the adoption of the liquidation basis (for example, the cumulative-effect adjustment) would affect the financial highlights information and whether the result would be meaningful to a user of the entity’s financial statements. A fund manager should consider whether financial highlights continue to be relevant and useful to understanding the fund’s statement of net assets in liquidation or statement of changes in net assets in liquidation. The TQA describes factors to consider in making that determination. If financial highlights are considered necessary, the fund manager should consider additional descriptions and/or disclosures other than those used in going concern financial statements.

**TIS SECTION 6910.43:**
“Accrued income when using the liquidation basis of accounting.”

This TQA discusses if an investment company should accrue income related to estimated earnings on its investments through the end of its estimated liquidation period. The TQA concludes that an entity should accrue income that it expects to earn through the end of liquidation if there is a reasonable basis to do so for all investments. Factors to be considered include investment-specific characteristics, general market conditions and estimated disposal date. The investment company is required to disclose the type and amount of income accrued in the statement of net assets in liquidation and the period over which the income is expected to be collected or earned.

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What Your ODD Failed to Identify:
Red Flags for Allocators and Investors

By Gautham Deshpande

Challenging markets, suboptimal returns, pressure to reduce management fees and performance fees, and increased operating costs are combining to make it tougher than ever for fund managers to stay in business. These challenges could create an environment in which there is an increased risk of fraud.

Allocators and investors need to be aware of, and on the lookout for, the following three conditions that are generally present when fraud occurs:

- **Incentives/Pressures** – A fund manager may be under pressure to achieve an expected investment result and therefore may have an incentive to falsify results to demonstrate a desired outcome and/or to earn performance-based compensation.

- **Opportunities** – An opportunity to commit fraud may exist when a fund manager is able to easily access cash and/or securities.

- **Attitudes/Rationalizations** – Fraud risk increases when the person(s) involved possess an attitude that allows them to rationalize committing the fraud (for example, thinking the losses will be made up in the future when performance improves or that the fraud is not significant to the investors or that they are ‘entitled’ to or have ‘earned’ the money based on past good performance).

What do allocators and investors do to identify pressure on fund managers that could lead to potential fraud? Due diligence focuses on a fund manager’s pedigree, track record, experience and expertise in managing investments. Background checks are used to identify bad actors or past anomalies. Tone at the top and a culture of compliance are always positive behaviors for a fund manager to exhibit. Other areas of focus include assets under management, fee structure, expense ratios, and the business plan of the fund manager.

Frauds perpetrated by fund managers when the three fraud risk conditions are present typically take one or both of the following forms:

- **Falsifying books and records** – This type of fraud entails altering a fund’s books and records to cover losses or create performance that does not exist. This is often achieved by creating investments or performance that does not exist and may involve collusion with “related parties.”

  **Misappropriating assets** – This type of fraud involves theft of the fund’s assets and is often accomplished by causing the fund to pay for a fictitious investment or diverting a payment to an investor (such as for a distribution). Accordingly, in a fund environment, a misappropriation of assets is often accompanied by falsified books and records in an attempt to cover up the fraud.

Regulators, in recent litigation, have increasingly focused their attention on related parties. What can allocators and investors do to identify related party relationships and transactions? Allocators and investors spend significant time identifying and understanding related party relationships and transactions. This is done through a combination of inquiries with the fund manager, review of legal documents and filings with the SEC or other agencies (Form ADV and other regulatory filings). Allocators and investors could also ask the manager for an exhaustive organization chart that includes a complete listing of all related entities, related individuals and their cross-relationships to help better understand related parties and relationships. However, when fraud is perpetuated, it is not what has already been disclosed to investors but usually something that has been hidden or not disclosed to allocators and investors that is the cause of investor losses.

How does one identify something that has been hidden or has not been disclosed? The key is to know and interact frequently with the fund manager. In addition, allocators and investors should obtain and review a fund’s audited financial statements and pay special attention to the related party disclosures to assess if they are consistent with their understanding of the
fund and its related party relationships.

Red flags that allocators and investors can look for include:

- Is the fund manager trading investments outside his area of expertise or has the investment portfolio drifted from the fund manager’s traditional focus or the expected areas of focus described in the fund’s legal documents (for example, “style drift”)?
- Do the fund’s legal documents properly explain all significant investment risks to the investors?
- Does the fund manager fully understand the significant risks involved in making the investment?
- Uncorrelated returns or exceptional returns defying market performance or logic.
- Poor documentation relating to ownership or purchase of an investment followed by poor documentation of investment risks involved.
- Unnecessarily complex investment products and or use of unnecessarily complex investment structures involving related parties.
- The fund manager is unable to articulate the investment and significant risks clearly.
- A sense of secrecy surrounding the investment either by citing confidentiality or competitive advantage.
- Involvement of related parties: the investments are made in or through related entities. Look out for the fund borrowing money or loaning money. As well as being irregular, this can possibly be a fraud risk as it indicates that the fund or manager has exhausted its ability to find capital elsewhere and therefore could be loaning money to the manager or related parties.
- Physical signs: aggressive behavior or unusually sugarcoated communications followed by aggressive behavior when confronted with tough questions.
- Other physical attributes: Does the manager exhibit an overly and unhealthy competitive streak in work or home life? Does the manager have a dominant personality? Is he/she unwilling to submit to any sort of checks and balances or scrutiny?
- Pressures at home: stagnant or lack of substantial growth in AUM. An office size/location and number of employees that is inconsistent with current AUM. A contraction of AUM without an appropriate level of downscaling. The use of high interest borrowing to sustain operations.
- Personal challenges: Life altering events such as going through a separation/divorce or significant medical condition involving the manager or a loved one.
- Using someone else’s money to either maintain an exorbitant and lavish lifestyle, or being very generous/holding big parties-paying for lavish social events.

Gatekeeper responsibilities: Several independent parties often act as gatekeepers to a private fund. Significant among those are the fund’s independent administrator and independent auditors. While investors and regulators have for a long time acknowledged the role of independent auditors, more recently fund administrators are being viewed as an important cog in the wheel for a private fund. Recent regulatory actions against administrators reinforce this view. It is an important step for allocators and investors to interact with the administrators and auditors or at least ask the fund for any significant written comments from gatekeepers impacting the fund operations.

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Alternative Investment Industry Outlook for Q1 and Beyond in 2017

By Elana Margulies-Snyderman

INTRODUCTION
The alternative industry appears to be in a position of anticipation, with investors and managers alike awaiting if and how the incoming Trump administration will impact the landscape. Putting the new Oval Office aside, at the beginning of 2017, looking at hedge funds specifically, investors expect increased consolidation, broad underperformance and for their current allocations to remain status quo. They also seem to prefer private equity. Family offices are set to be more opportunistic than institutions with respect to strategy preference but quant strategies, specifically risk premia, appears to be a favorite thus far for both investor groups. With respect to launches, EisnerAmper sees a healthy pipeline in the start-up space, although capital raising still remains one of the biggest challenges for hedge funds. On the private equity side, it looks much less so as they are looking to put the capital to work this year.

INVESTOR SENTIMENT
Capital introductions personnel from the biggest prime brokerage firms to second tier organizations and boutique operations have told EisnerAmper that investors globally, both institutions and family offices, anticipate greater hedge fund consolidation, management fee compression and broad hedge fund underperformance, to name a few common themes for the industry this year.

Regarding their general allocation plans to hedge funds, capital introductions personnel noted that the majority of them do not plan to redeem from hedge funds or even reduce their own allocations, but are focused on replacing or upgrading existing managers rather than allocating to new ones. Further, they’re eyeing more exposure to private equity.

Looking at their strategy appetite, although preference varied amongst investors on different continents, and family offices appear to be more opportunistic than institutions, some common themes include favoritism toward various quantitative strategies, in particular quant equity and CTAs, given these offerings provide risk diversification, beta reduction and absolute return. In addition, another quantitative strategy they are all favoring is risk premia, given they offer more transparency and have lower fees than typical hedge fund structures. Further, investors worldwide are also eyeing distressed credit.

Additionally, other strategies of interest amongst institutions include “niche” offerings, with direct lending being one example or more esoteric ones; fixed-income relative value, which was popular all of last year; and finally, equity long/short and global macro, which just more recently started to pique investor attention.

On the less liquid side, there is an expected appetite for hybrid hedge fund/private equity vehicles and illiquid multi-asset class credit solutions.

Ethan Boothe, Principal-In-Charge, Texas Region, EisnerAmper, confirmed that as many institutional investors have moved away from hedge funds as an asset class in 2016, there is still a strong appetite for private equity by the LP investors.

“This is driven by the steady and favorable return-on-investments and risk-profile,” he said.

Alternatively, institutions appear underwhelmed by fundamental and directional strategies looking ahead.

In addition to quantitative offerings, especially risk premia, family offices are expressing an appetite for allocating to emerging managers and continue to be opportunistic when it comes to strategy. Some strategies of interest amongst this investor group include sector-focused offerings, either a focus on a specific area such as a health care or a multi-sector fund; and financials given their outperformance following the U.S. presidential election.

LAUNCH ACTIVITY
Launch activity this quarter and further into 2017 is expected to pick up and EisnerAmper sees a healthy pipeline of start-
ups, both in hedge funds and private equity. Raising capital continues to remain one of the biggest challenges for hedge funds, while, on the other hand, private equity managers have raised capital which they are expected to put to work this year.

“In California, we are seeing a good amount of activity in the start-up space,” said Eugene Tetlow, Business Development Manager in EisnerAmper’s San Francisco office. “There has been a steady momentum building and a number of funds are planning to launch in the first half of the year. In regards to AUM, the community remains cautiously optimistic that a number of these new launches will get seed deals ranging in size, but I still expect the majority to launch with less than $100 million.”

Several capital introductions personnel told EisnerAmper that capital raising for most start-up hedge funds continues to remain challenging, prompting some to postpone their launches until the second quarter or later this year.

Jeff Parker, Partner in EisnerAmper’s New York office added: “The new year is bringing renewed optimism in the industry, as the improved market of the past few months has been joined by the potential for less regulation. New launches seem to indicate that enthusiasm.”

In other financial centers in the U.S., the launch pipeline in the private equity space remains robust.

“Over the last 4-5 months, we have seen many new launches as a result of people spinning out of existing Florida-based private equity funds,” said Michael Mazzola, Partner in EisnerAmper’s Miami office.

“A new trend we are seeing is many GPs have raised capital and put together one-off (sidecar) ‘niche funds’ which allow LP investors to focus their investment not only with a private equity asset class, but a very specific sector or subsector based on the private equity niche and investment thesis,” Boothe added. “Look for the continuation of a highly competitive market in 2017. Rates are rising but remain near historical lows, so senior debt remains cheap and accessible for deals. As in 2016, there are just simply fewer quality deals on the market. Unless the proprietary/unicorn is in play, there will be multiple players both financial and strategic that are chasing and indeed fighting over ‘good investment companies’ when an opportunity comes to market. Furthermore, the funds raised vintage 2015 and 2016 provide significant dry powder for private equity investment partners who will be looking to put that capital to work in 2017 as that capital has defined time brackets.”

CONCLUSION

With the year only a couple of months old, it will be interesting to see if investors allocation plans for hedge fund and private equity come to fruition in 2017. And if that is the case, quant strategies, namely risk premia offerings, should receive new inflows of capital, along with private equity given its lucrative return-on-investments. Further, with planned start-ups across financial centers nationwide in the U.S., launches are on track to increase for both hedge funds and private equity.

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Mutual Funds and ETFs: A New Liquidity Risk Management Regime

By Venkat Rao

BACKGROUND
On October 13, 2016, the SEC unanimously approved rules requiring open-end funds, including mutual funds and exchange traded funds (“ETFs”), to adopt liquidity risk management programs and permit mutual funds to use “swing pricing,” subject to specific requirements. The Commission also enhanced data reporting requirements for mutual funds and ETFs.

Open-end funds are an attractive investment option for many different types of investors because they provide diversification, economies of scale and professional management. They also facilitate retail investors’ access to certain investment strategies or markets that might be difficult, too time-consuming, or impossible for investors to replicate on their own. In recent years, retail investors have increasingly relied on investments in open-end funds for saving for life events, such as retirement or a child’s college education. Institutional investors have also gravitated to open-end funds as part of their trading and hedging strategies. As recently as 2014, investors hold over $12 trillion in mutual fund assets.

This broad investor interest has prompted liquidity concerns by regulators in the event of a crisis. The Financial Stability Oversight Council (“FSOC”) expressed particular concerns about the ability of mutual funds to sell shares during a crisis. In September 2015, the SEC, whose chairman is a voting member of the FSOC, proposed the new rule requiring most open-end funds to adopt a liquidity risk management program. Mutual fund liquidity concerns came more into focus in December 2015 when a prominent New York mutual fund containing large junk bond positions plummeted in value, prompting the fund to take the rare step of halting redemptions while winding down the fund through the disposition of assets at “fire sale” prices. The SEC is concerned that investor redemption rights may be compromised with more illiquid mutual funds or ETFs. Given recent developments, open-end funds with fewer liquid assets are viewed as especially vulnerable.

COMPONENTS OF THE LIQUIDITY RISK MANAGEMENT RULE
The SEC’s rule can be broken down into 3 primary categories:

- Adoption of a liquidity risk program;
- Use of swing pricing; and
- Additional liquidity risk disclosures.

LIQUIDITY RISK PROGRAM
The Commission seeks to promote liquidity risk management standards in open-end funds to address issues arising from modern portfolio construction of open-end funds, particularly funds investing in more illiquid securities. Under the new rule, the SEC will generally require an open-end fund’s liquidity risk program to include the following:

- Assessment, management and periodic review of liquidity risk;
- Classification of liquidity of fund portfolio investments into the following 4 categories based on the ability to convert into cash without significantly altering the investment’s market value:
  - Highly liquid: can be converted into cash in 3 business days;
  - Moderately liquid: can be converted into cash in 4 to 7 calendar days;
  - Less Liquid: can be sold or disposed of in 7 calendar days, but settlement may take longer; and
  - Illiquid: cannot be sold in 7 calendar days;
- Determination by each fund of a highly liquid asset minimum;
- Annual reports to the board on the highly liquid asset minimum annually, and any time the fund fell below the minimum threshold;
- 15% limit on illiquid investments;
• Monthly review of illiquid investments;
• Reporting and remediation of breaches of the 15% Illiquid Investment Limit;
• Board oversight of liquidity risk management program; and
• Filing of Form N-LIQUID for breaches of the illiquid investment limit.

SWING PRICING
Swing pricing is the practice of allocating transaction costs of trading activity to the most active traders, and functions as an anti-dilution tool used to adjust a fund’s net asset value ("NAV") in order to protect existing shareholders from purchases and redemptions. The new rule permits mutual funds (but not ETFs or money market funds) to use swing pricing to help manage liquidity risks provided that their policies and procedures:

• Document the process for determining:
  – Swing threshold – a pre-determined percentage of fund’s NAV based on asset class and capital activity of the fund;
  – Swing factor – a specified amount to adjust the NAV once the level of inflows or outflows are determined;
• Establish an upper limit on the swing factor, not to exceed 2% of the NAV per share;
• Be approved by the fund’s board; and
• Be required to periodically review its swing policy for the adequacy and effectiveness of implementation. Any changes to the swing factor’s upper limit or the swing threshold must be approved by the board.

ENHANCED REPORTING REQUIREMENTS
Under the new rule, the SEC has implemented new reporting requirements for registered investment companies with the purpose of enhancing the quality of information available to investors. The SEC will also collect and use the reported data to perform more targeted examinations.

The following is a summary of the new and enhanced reporting requirements:

• Form N-PORT: This form requires registered funds (except money market funds) to provide monthly reporting via a structured data format of the fund’s investments. The information collected will include:
  – Classification for each investment across the 4 liquidity risk categories;
  – Aggregate percentage of fund in each of the 4 liquidity categories;
  – Highly liquid minimum; and
  – Percentage of highly liquid investments segregated to cover derivatives.
• Form N-CEN: The new form would require all registered investment companies to report census information through a structured data format, including:
  – Deployment of lines of credit;
  – Inter-fund borrowing and lending; and
  – Whether an ETF qualifies as an “in-kind” ETF.
• Form N-LIQUID: The new form would require investment companies, including in-kind ETFs, to confidentially report when a fund’s illiquid assets exceed the 15% limit.
• Fund Financial Statements: Funds will be required to provide enhanced reporting in financial statements, including information on derivatives; and
• Enhanced Securities Lending Disclosures: Funds will need to disclose fees paid to securities lending agents in registration statements.

IMPACT
There are currently 2 kinds of open-end funds largely affected by this rule: mutual funds and ETFs. Since open-end funds are considered to be redeemable securities, Section 22(e) of the Investment Company Act of 1940 ("IC Act") requires them to make payments to shareholders for securities tendered for redemption within 7 days of their tender, except in extraordinary circumstances. In actual practice, mutual funds typically pay on a next day basis, while ETFs follow the broker-dealer “regular way” settlement process (currently T+3, but expected to change to T+2). Under the IC Act, shares must be redeemed at a price approximately their proportionate share of the fund’s net asset value at the time of redemption.

Open-end funds with highly liquid assets, such as investment grade equities and bonds, are unlikely to be significantly affected by the proposal because they can more easily meet redemption requests within the 7 day deadline. Nevertheless, severe market conditions, similar to the 2008 financial crisis, could impact funds containing a large percentage of securities normally deemed highly liquid.

The rule will impact personnel responsible for managing liquidity risk. Portfolio managers and traders certainly have significant roles with respect to managing liquidity, but risk and compliance managers will have more responsibilities. Risk managers usually have periodic reporting to risk committees to ensure senior management receives adequate information to guide a fund’s liquidity practices. Compliance officers are charged with the duties of administering policies and
procedures, which may include compliance with liquidity parameters. Most importantly, a strong governance structure will allow all firm personnel to properly manage a fund’s liquidity and meet the requirements of the proposed rule.

**CONCLUSION**

Most funds must comply with the new rule and file Forms N-PORT and N-CEN by December 1, 2018. Fund complexes with less than $1 billion in net assets will be required to comply the rules and file the Form N-PORT by June 1, 2019. To meet the requirements of the rule, mutual fund and ETF managers should be addressing several practical issues, including but not limited to:

- Assessment of current liquidity levels of fund assets;
- Classification of assets into liquidity buckets;
- Determining proper level of minimum liquid asset thresholds;
- Creating liquidity risk management policies and procedures; and
- Considering the use of additional liquidity risk management techniques (e.g., swing pricing, collateral management, committed credit lines, etc.).

Fund managers should be preparing their liquidity risk policies and implementing the governance framework in advance of the deadlines.

**SOURCES:**


2. September 2015, SEC’s Division of Economic and Risk Analysis (“DERA”). DERA noted that assets held by U.S. mutual funds grew from $4.4 trillion to $12.7 trillion between 2000 and 2014.

3. Money market funds are another type of open-end fund but are already subject to rule 2a-7 and are largely excluded from this rule and discussion.  


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