Virtual Annual Investment Industry Seminar

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Practical Highlights GIPS 2020

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Learning Objectives

1. Effective Date and Transition
2. Treatment of Funds
3. New Distribution Requirements
4. Composite Construction
5. Composite/Pooled Fund Listings and Descriptions
6. AUA and AUM Changes
7. GIPS Report Updates
8. GIPS Report Distribution
9. Carve-Outs
10. Verification Updates
11. Wrap Accounts and Estimated Transaction Costs
12. Other Practical Considerations

GIPS 2020 Is Here!

- Improves the standards
- Eases the burden of compliance
- Makes the process more relevant for many firms in the investment industry
- Expands applicability for:
  - Firms that manage pooled investment vehicles
  - Firms that manage alternative asset classes
  - Asset owners

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Effective Dates

- Effective Date – 1/1/2020. This mainly relates to maintaining underlying data / calculations as the reporting deadlines don't come into play until later.
- GIPS Reports that include performance through or past 12/31/2020 must be prepared using GIPS 2020.
- GIPS Reports with performance that ends earlier than 12/31/2020 (such as YTD through 6/30/2020) may still use GIPS 2010.
- Early Adoption is allowed
  - If a firm early adopts, can't do so half way. Either a firm is fully in, or out.

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Poll question coming up next

Treatment of Funds

- Many firms that focused on managing funds not well served by 2010 version of GIPS
- Prior versions designed from a composite centric view, requiring limited distribution pooled funds (LDPFs) and broad distribution pooled funds (BDPFs) to be lumped into composites

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Treatment of Funds

- What are segregated accounts?
  - A portfolio owned by a single client. Foundation of GIPS 2010. These are not funds under GIPS 2020.
- What are BDPFs?
  - Regulated under a framework that permits the public to purchase or hold shares
  - Not exclusively offered in one-on-one presentations (this clause is designed to address multi-share class funds distributed differently)
  - Example – 40 Act mutual funds
- What are LDPFs?
  - Any pooled fund that is not a BDPF
  - Examples – hedge funds and PE funds

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Treatment of Funds

- GIPS reports not required for BDPFs
  - Already subject to regulatory frameworks
  - Many single fund composites not deemed useful
- “Compliant presentations” replaced with “GIPS composite reports” – for composites
- “GIPS Pooled Fund Reports” – new category of reports
  - LDPFs can be included in separate GIPS pooled fund reports
  - BDPFs can also be included in separate GIPS pooled fund reports, but we don’t expect many firms to do this
  - Can use gross or net returns for GIPS pooled fund reports

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Treatment of Funds

- "GIPS Pooled Fund Reports" – new category of reports (continued)
  - The purpose of creating a GIPS pooled fund report was to facilitate a more appropriate method for providing GIPS-compliant information to prospective pooled fund investors.
  - There are a few less requirements in a GIPS pooled fund report as compared to a GIPS composite report, such as the number of portfolios and a measure of internal dispersion.
  - Additional disclosure – expense ratio: The pooled fund expense ratio is similar to the expense ratio that a mutual fund would report in its annual financial statements.

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Treatment of Funds

- What is required to be provided to prospective investors for BDPFs?
  - Nothing
  - Could provide a composite report that contained the BDPF
  - Could provide a pooled fund report for the BDPF

- What is required to be provided to prospective investors of LDPFs?
  - GIPS pooled fund report, or a GIPS composite report that contains the LDPF, when the investor initially becomes an LDPF prospect and at least every 12 months, assuming they remain an LDPF prospective investor

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Composite Construction

- Segregated accounts
  - All fee paying, discretionary segregated accounts are required to be included in at least one composite
  - Sub-advised and single-investor pooled funds should be treated as segregated accounts, and not pooled funds
- Pooled Funds (LDPFs & BDPFs)
  - Not required to create or maintain a composite that includes only one or more pooled funds if firm does not offer pooled fund strategy for segregated accounts
    - Firms may terminate single member pooled fund composites previously kept under the 2010 GIPS standards
  - If firm offers pooled fund strategy for segregated accounts, pooled fund must be included in composite with segregated accounts
    - Firms are no longer allowed to exclude portfolios from composites based solely on legal structure

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Composite and Pooled Fund Lists/ Descriptions

- Composites
  - Must maintain composite listing with descriptions, as well as terminated composites for at least 5 years
  - Composite description may need to be updated to reflect:
    - Material risks pertinent to the strategy
    - The use of leverage, derivatives, and short positions, if considered to be a material part of the strategy
    - Inclusion of illiquid investments, if considered a material part of the strategy
- Pooled Funds
  - Must maintain a listing of limited distribution pooled funds with pooled fund descriptions
  - No requirement to include terminated pooled funds on pooled fund listing
  - Must maintain a listing of broad distribution pooled fund, not required to include a pooled fund description

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AUA and AUM

- Changes to AUM
  - No longer permitted to show composite assets as a percentage of total firm assets, must present total firm assets for annual periods ending on or after December 31, 2020
  - Firms can still present composite assets as a percentage of total firm assets for annual periods prior to December 31, 2020
  - New requirement that firms must exclude uncalled committed capital, but could present separately
- Changes to AUA
  - 2020 GIPS standards developed provisions for the reporting of advisory only assets
  - Advisory-only assets may be presented at either the composite level or total firm level
  - Not allowed to include advisory-only assets in the calculation of composite assets
  - Firms are permitted to present advisory only assets as:
    - A separate value, or
    - The combination of composite assets and composite advisory-only assets
  - Must be clearly labeled
  - No longer required to label as supplementary information

Poll question coming up next

GIPS Report Updates

- 2010 version – No deadlines for updating compliant presentations
- GIPS 2020 exposure draft proposed a 6 month deadline
- GIPS 2020
  - Must update GIPS reports within 12 months
  - Recommends updating GIPS reports on a quarterly basis (not required)
  - Per the Explanations of Provisions, when updating more frequently than annually (i.e. quarterly, monthly):
    - TWRR GIPS Reports - firms are required to only update the composite or pooled fund returns, benchmark returns, and significant events that would help a prospective client or investor understand the GIPS report.
    - MWRR GIPS Reports - firms are required to only update the composite or pooled fund returns, benchmark returns, the required multiples (think RE), as of the most recent quarter end or month end, and significant events that would help a prospective client or investor understand the GIPS report.

Distribution of GIPS Reports

- Provision 1.A.17 – The firm must be able to demonstrate how it made every reasonable effort to provide:
  - A GIPS composite report to those prospective clients required to receive a GIPS composite report
  - A GIPS pooled fund report or GIPS composite report to those LDPF prospective investors required to receive a GIPS pooled fund report or a GIPS composite report
- GIPS Verification standards published by the CFA institute require that verifiers now perform sufficient procedures to determine that the firm made every reasonable effort to provide the appropriate GIPS reports to prospective clients and investors
- What this means for firms:
  - Develop robust policies and procedures for tracking the distribution of GIPS reports to prospects
  - Document and retain support for which reports were disseminated to which prospects and when
  - The Explanations of Provisions issued by the CFA Institute suggest using a checklist to document and track the distribution of the GIPS reports
  - Other viable options include, excel-based tracking, using client relationship management (CRM system), email searches/name-based searches, other proprietary software

Carve-Outs

- Pre-GIPS 2010 – Firms allowed to include carve-outs with allocated cash in composites
  - This occurs where a firm pulls out a segment of a portfolio along with a portion of the related cash account
  - Common example – balanced accounts
- Carve-outs were banned in 2010 version of GIPS
  - A LOT of heated debate surrounding carve-outs led to the ban
  - Complaints included: a) cherry-picking, b) allocating cash doesn't fully reflect the reality of managing a portfolio with its own separate cash account, c) the carve-out didn't represent a legitimate strategy (such as carving two securities out)

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Carve-Outs

- Why bring carve-outs back?
  - Private wealth managers
    - Building blocks approach to portfolio construction
    - Can assemble building blocks without setting up several separate cash accounts
    - High amount of tailoring/customization of portfolios = high dispersion
  - Alts managers (especially PE)
    - Several firms expressed interest in having the ability to separately report segments
    - For example – a firm managing a Technology fund might wish to separately report performance of startups from more established firms

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Carve-Outs

- GIPS 2020 – Reintroduces carve-outs with allocated cash, but puts restrictions in place to address previous concerns
  - Must be representative of stand-alone portfolio managed or intended to be managed to that strategy.
  - For a stand-alone portfolio that is the same strategy of carve-out with allocated cash, must create additional separate composite that only contains stand-alone portfolios. Designed to address carve-out vs. separate acct consistency concerns.
  - If a segment of an account is carved out to be included in a composite, must pull that strategy segment out of every account in the firm that contains it. Designed to address cherry-picking concerns.
  - Cannot combine different composites, funds, or carve-outs to create a simulated strategy.

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Carve-Outs

- GIPS 2020 – How is cash to be allocated?
  - Adopting release for GIPS 2020 notes that guidance will be provided in the GIPS Handbook.
  - The Explanations of Provision 3 published by the CFA Institute provide the following acceptable methodologies for allocating cash synthetically to carve-outs on a timely and consistent basis:
    - Beginning-of-Period Cash Allocation
    - Beginning-of-Period Plus Weighted Cash Flow Allocation
    - Strategic Asset Cash Allocation (true up actual)
    - Strategic Asset Cash Allocation (target weights)
  - Firms must determine which method to use for each composite, document it in their policies and procedures, and apply the method consistently.
  - Regardless of the allocation methodology selected, GIPS 2020 requires firms to disclose the policy within the compliant GIPS composite report.

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Carve-Outs

- Additional disclosure requirements
  - The percentage of composites only for carve-outs that allocate cash. As such, firms need not present the percentage of carve-outs that maintain separate cash accounts
  - Composite name needs to indicate that the composite contains carve-outs with allocated cash
  - For composites including both carve-outs with allocated cash and standalone portfolios – need to present composite returns and asset market values of the standalone portfolios segment for each annual period end
  - Need to disclose that the GIPS composite report for the composite standalone portfolios is available upon request, if it exists
  - NOF returns – need to represent what would be charged to a prospective client (multi asset or stand alone)

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GIPS Verification

- Changes
  - Compliance statement was updated and therefore GIPS reports should be updated as well
- New Testing
  - Outlier returns – review of portfolio returns within select composites to identify any material deviations
  - Model Fees – perform testing to determine actual fees are not higher
  - Distribution of GIPS Reports – perform testing to determine that firm has made every reasonable effort to provide GIPS reports to all prospective clients and investors
  - Marketing and Advertising Materials – determine that materials are accurate and in accordance with the GIPS advertising guidelines (section 8)
  - Error Correction – determine that errors have been treated in accordance with error correction policy

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Wrap Accounts

- Wrap Accounts – Taking highest fee under GIPS 2010 because transaction costs are unknown. In GIPS 2020, transaction costs can be estimated. How does a firm do this?
  - In 2020, firms may use either actual or estimated transaction costs for portfolios included in composites
    - May only do for portfolios for which actual transaction costs are unknown.
  - New required disclosure – If est. trans costs are used, must disclose the estimated transaction costs used, and how they were determined
  - Per the Explanation of Provisions in Section 2, acceptable methods of estimating transaction costs include basing estimated transaction costs on:
    - actual transaction costs for portfolios that the firm manages in the same or similar strategy, or
    - actual transaction costs for similar securities that trade in a similar market
  - Estimated transactions costs can take the form of a percentage of cost that is then applied to the portfolio return, or as a monetary value
    - If using a monetary value, GIPS recommends scaling amount for size of transaction
  - Also – Firms are not required to estimate transaction costs. WRAP composites can continue to be shown with using the highest model fee.

More GIPS 2020 Changes

- Disclosures – some additional changes
  - The firm must disclose the following in GIPS reports: “GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.”
    - Needs to go into verification and performance exam reports too.
  - Must disclose creation date and inception date. Many firms were already doing this. GIPS 2010 only required creation date.
  - Benchmarks – you can show more than one. Need to provide all of the stats and required disclosures for each benchmark presented.
  - Sunset provisions – disclose for at least 1 yr. Remove when not relevant.
    - Significant events
    - Composite name changes
    - Benchmark changes
    - Correction of material error
    - MWR to TWR (or vice versa)

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More GIPS 2020 Changes

- Portability
  - Optional under GIPS 2020. Was mandatory under GIPS 2010 if criteria were met.
  - GIPS 2020 criteria are as follows:
    - Decision makers – substantially at new firm
    - Decision making process – substantially the same
    - Records to support performance
    - No break in track record (required to link returns). Similar concept to a break in a composite.
      - If there is a break – a firm can still use the performance from the past firm. But linking the performance is not permitted.
  - One year grace period – compliant firm won't lose GIPS compliant status while it works to achieve firm-wide compliance.
    - Because portability is optional, this means that if a compliant firm buys a non-compliant firm, it has 1 yr to get things compliant on a GO FORWARD basis. No history needs to be brought over.
    - Should the firm decide to port history, it can do so. And it can do so on a composite by composite basis.
  - Provisions 1.A.32-33 address portability (32 – no break, firms can link; 33 – break, can't link). 1.A.34 addresses maintaining compliance.

Questions?

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Objectives Covered

1. Effective Date and Transition
2. Treatment of Funds
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Contact the Presenter

Thomas A. Peters
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Thomas Peters leads Kreischer Miller's Investment Industry Group. Tom has a wide range of experience providing GIPS, operational due diligence, compliance, and audit services to firms in the investment industry, including investment managers, investment funds, institutional investors, and broker-dealers. Tom has served on several investment performance committees in the industry. He currently serves as a member of the GIPS Technical Committee.

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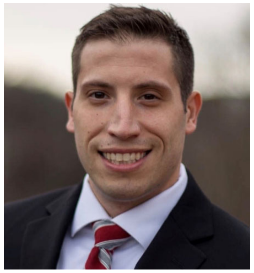

Joshua E. Kramer
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Josh has a wide variety of experience within the investment industry, including providing traditional audit and attestation services to investment managers, broker-dealers, and closely-held funds. Josh specializes in the performance of firm-wide verifications and composite examinations for investment managers claiming compliance with the Global Investment Performance Standards (GIPS).

In addition, Josh has assisted investment firms, seeking to make a claim of compliance with the GIPS Standards, in developing sound policies and procedures consistent with widely accepted practices related to the calculation and presentation of investment performance. Josh currently serves as member of the United States Investment Performance Committee (USIPC).

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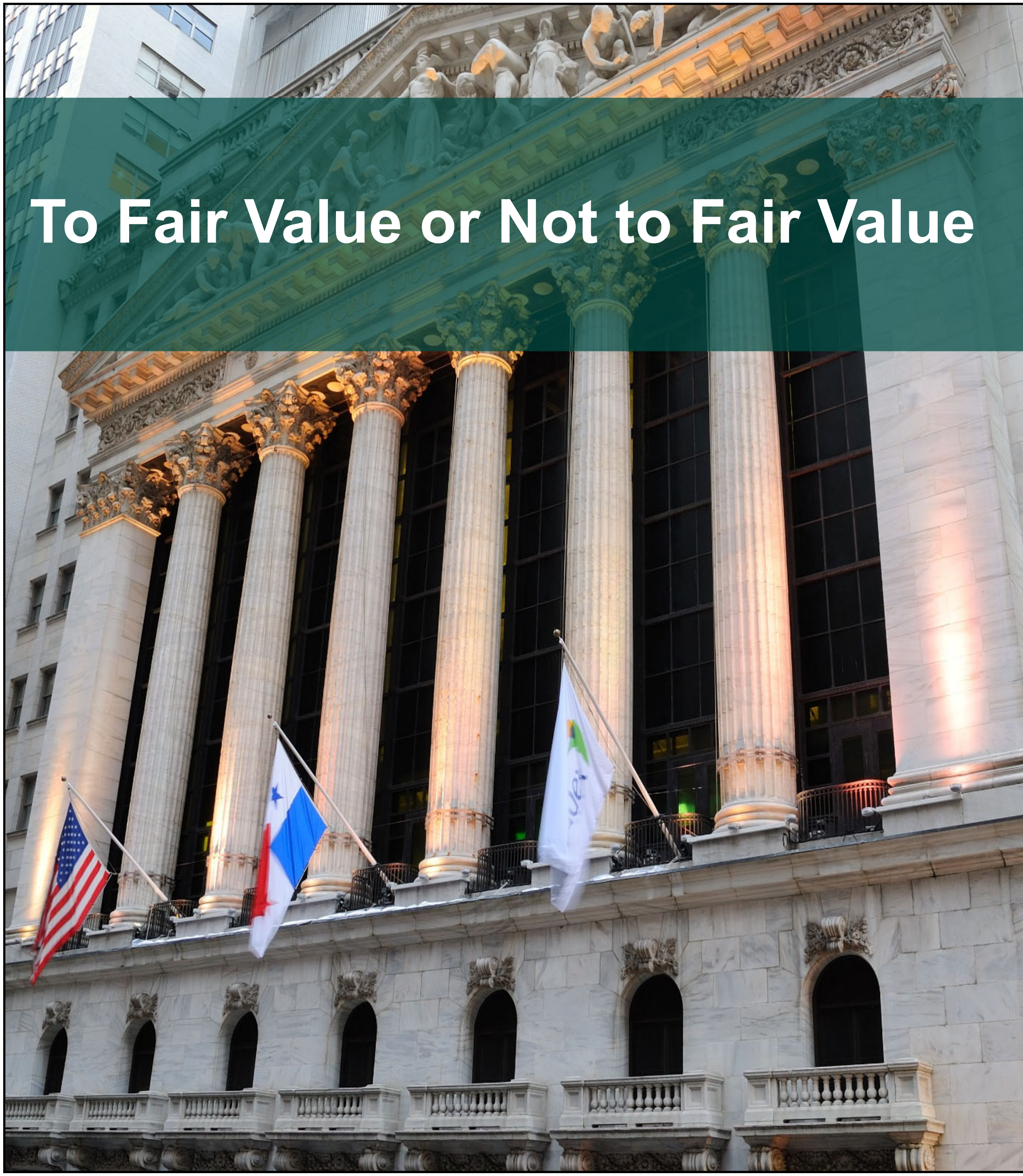
Break

Our next session will resume at 10:10am.

To Fair Value or Not to Fair Value



Todd E. Crouthamel,
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Agenda

To Fair Value or Not to Fair Value

1. Characteristics of an Investment Company
2. Non-investment Company Accounting for Investments

To Fair Value or Not to Fair Value

- Not as Simple as it may appear
  - Clients, their Board Members and Audit Committees have had increasing questions surrounding accounting for investments
  - Specifically, when is fair value required?

The Answer to this Question is: **It Depends**

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To Fair Value or Not to Fair Value
A Look at the Numbers

- Since 2016:
  - 7 Accounting Standards Updates (ASUs) regarding accounting for investments
  - 10 sections of the FASB Codification address accounting for investments
    - Excluding ASC 946 – Investment Company Guidance
    - Non Profit Accounting

  - This is a significant amount of guidance to muddle through
  - We will not cover all of it, but will answer the question:

To Fair Value or Not to Fair Value?

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First Stop – ASC 946 *Financial Services – Investment Companies*

- First Stop – ASC 946
  - If an entity meets the definition of an investment company in accordance with GAAP, the answer to the Fair Value question is a resounding YES!
    - Financial statements have different names, different layout and include a schedule of investments
    - Required to disclose financial highlights including total return and income / expense ratios
    - Disclosures are different

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What is an Investment Company Under ASC 946

- An Investment Company:
  - Automatically includes 40 Act Funds – **Fair Value**
  - Specifically Excludes Real Estate Investment Trusts (REITS) – **Cost**
  - Has Fundamental Characteristics
  - May have Typical Characteristics

  - Entities that are not 40 Act Funds or REITS must analyze the characteristics detailed in ASC 946 to determine if the entity should account for its investment portfolio in accordance with ASC 946, or other areas of GAAP, including ASC 320 and ASC 321

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ASC 946 – Fundamental & Typical Characteristics

- Fundamental Characteristics:
  - If an entity meets all of the Fundamental Characteristics
    - It is an investment company – **Fair Value**

- Typical Characteristics
  - Provided for additional guidance and entity does not need to satisfy all of the typical characteristics

- Judgment
  - There may be instances where judgment is involved. Consider:
    - Business purpose of the entity
    - Reason for performing current activities
    - How the is entity marketed or presented to current and/or potential investors

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ASC 946 – Fundamental Characteristics

- Fundamental Characteristics – An entity is an investment company if it does **<u>both</u>** of the following:
  - Obtains funds from one or more investors and provides them with investment management services
  - Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for:
    - Capital Appreciation
    - Current Income
    - Or Both
- These points get to the business purpose. Often described in:
  - Offering memorandum
  - Partnership agreement
  - Other entity formation documents

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ASC 946 – Fundamental Characteristics – Real Estate Case

- Consider an entity that holds real estate, and evaluate the business purpose of the entity:
  - Entity A invests in a commercial building. It pools funds together, purchases the building, and collects rents. The GP is responsible for renting the building, paying expenses, maintenance, marketing, etc. The involvement and operations of an investee, does not preclude this entity from meeting the fundamental characteristics, as long as the business purpose is to maximize the returns of the entity. (Fair Value)
  - Contrast that with an entity that invests in a commercial building (the owners of which are all family members) and the building is leased to a manufacturing facility (also owned by the family). This is not an investment company, because the entity exists to facilitate the manufacturing business. (Cost)

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ASC 946 – Typical Characteristics

- There are several Typical Characteristics. Do not need to meet all of these characteristics and in some cases may not meet any of them.
  - More than One Investment
    - New entity, in the investment phase may not meet this
    - Real estate where many investors are not able to purchase a commercial building on their own, but can participate if they pool capital
  - More than One Investor
    - Master feeder arrangements may have one investor
    - New funds may have one investor
  - Investors are not related parties of the parent company or the investment manager
    - This is included because unrelated parties are less likely to have an objective of obtaining other benefits from the investment (like the related party example where the real estate is rented to the manufacturer)

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ASC 946 – Typical Characteristics (cont.)

- Typical Characteristics, *continued*
  - Ownership Interests in the Form of Equity or Partnership Interests
    - Could have multiple classes of equity with differing:
      - Rights
      - Fees
      - Redemption terms
      - And more
  - Substantially all of its assets are managed on a fair value basis
    - The type of investment does not matter, but is fair value of a component of:
      - How the entity evaluates performance, including reporting IRR or similar metrics
      - How the entity transacts with its investors
      - How fees are calculated (asset based)
- Entities that meet ASC 946 are investment companies and report **Fair Value**

Poll question coming up next

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Debt Securities – Non ASC 946

- If an entity does not meet ASC 946, should the investments be recorded at cost or fair value?
- ASC 320 is applicable to Debt Instruments and there are 3 classifications:
  - Trading (Intent to hold for a short period and sell) – **Fair Value**
  - Held to Maturity (intent to hold to maturity and receive par) – **Fair Value**
  - Available for Sale (neither Trading or HTM) – **Amortized Cost**

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Equity Securities – Non ASC 946

- If an entity does not meet ASC 946, should the investments be recorded at cost or fair value?
- ASC 321 is applicable to equity securities.
  - Generally, requirement is to report at **Fair Value**
  - Determine if the securities have a “readily determinable fair value”
    - Publicly traded stock, including mutual funds or ETFs – **Fair Value**

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Equity Securities – Non ASC 946
No Readily Determinable Fair Value

- ASC 946 is not applicable, and the securities have no "readily determinable fair value"
  - Can you use the "NAV as a Practical Expedient"
    - Only applies to those investments in funds that follow ASC 946. Since those assets are reported at fair value, fair value is available, and the investment would be at reported at **Fair Value**
  - No NAV as a Practical Expedient
    - A choice to be made:
      - Fair Value Option – Elect to report at **Fair Value**
      - **Cost**, assessed for impairment and changes made for observable price changes

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The Answer to the Question – To Fair Value or Not to Fair Value

- It Depends
  - Meet Definition of Investment Company (ASC 946) – **Fair Value**
  - Debt Securities under ASC 320 – **Cost or Fair Value**, depending on classification
  - Equity Securities under ASC 321
    - Readily Determinable Fair Value – **Fair Value**
    - Practical Expedient – **Fair Value**
    - Fair Value Option – **Fair Value**
    - Everything Else – **Cost**, adjusted for **Impairment and Observable Price Changes**

In Most Cases, the Answer is **Fair Value**

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Contact the Presenter

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Todd Crouthamel has extensive experience in the investment industry, including providing traditional audit services to investment managers, hedge funds, and broker/dealers, as well as performing custody examinations, in accordance with the Securities and Exchange Commission Rule 206(4)-2. Todd also serves as the leader of Kreischer Miller's Audit and Accounting Practice. In this role, Todd is responsible for managing the resources of the Audit and Accounting Practice including, training and recruiting, budgeting, serving as a resource on technical matters and development and maintenance of compliance policies and procedures.

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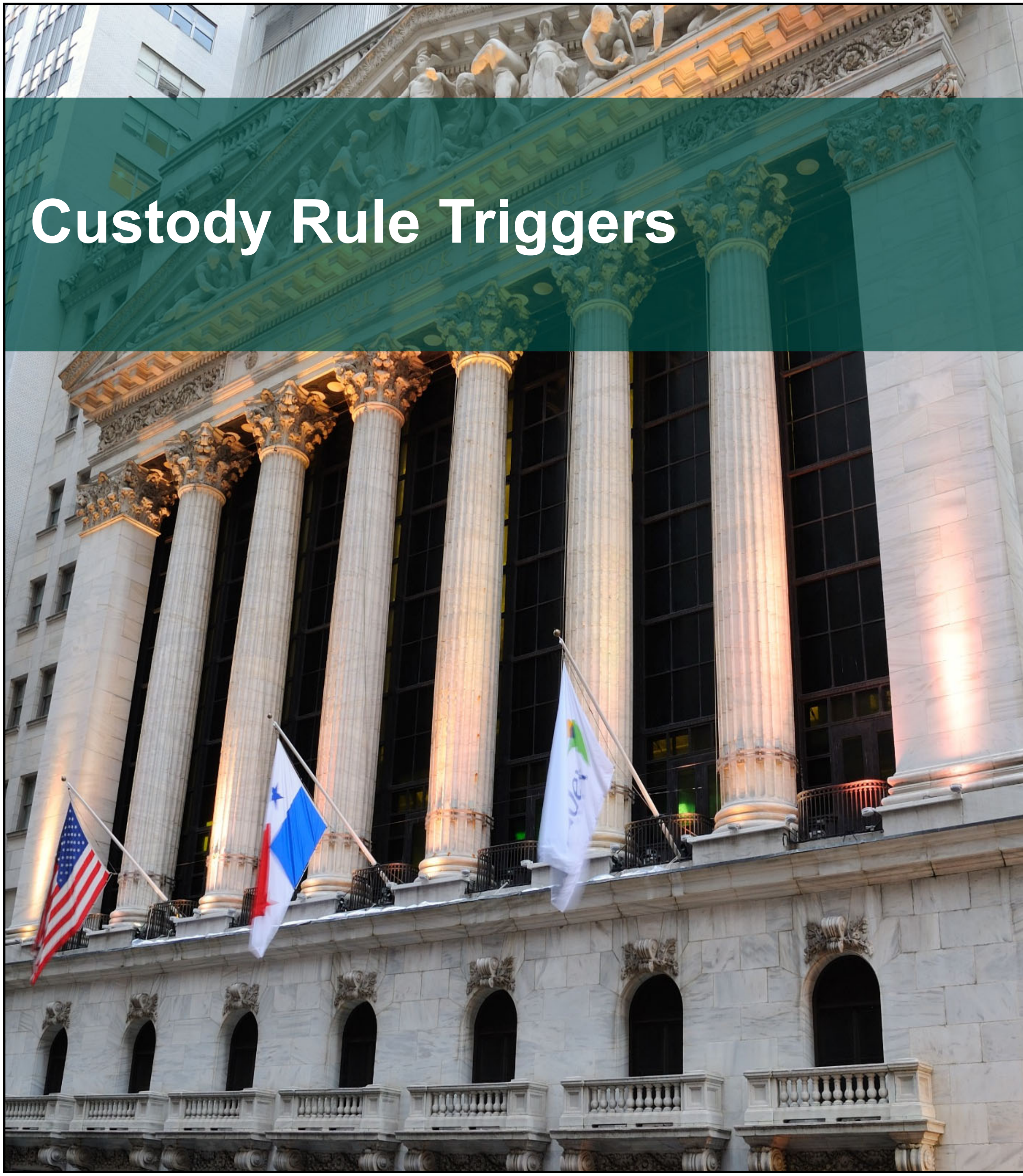
Custody Rule Triggers



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Agenda

1. A brief reminder of Custody Rule requirements
2. A look at a few common pitfalls and considerations of the Custody Rule
3. A reminder of a few changes resulting from COVID

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Custody Rule Requirements

- Section 206(4)-2 of the Investment Advisers Act of 1940
- Other supporting guidance:
  - IA-2968
  - IA-2969
  - Staff Responses to Questions About the Custody Rule
    - https://www.sec.gov/divisions/investment/custody_faq_030510.htm
- RIAs deemed to have custody when hold "directly or indirectly, client funds or securities or has any authority to obtain possession of them"
  - Actual possession (e.g. check made out to the advisor)
  - Legal control (e.g. trustee of a trust)
    - Exemption for automatic deduction of advisory fees

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Custody Rule Requirements

- Not illegal to have custody
- Adds additional oversight:
  - Annual "surprise" exam
    - For pooled investment vehicles, requirement may be waived
      - Must have an annual audit in accordance with US GAAP
- Notification requirements for account openings and statements
- Must use a "qualified" third-party custodian

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Common Pitfalls and Considerations

- Bill-pay services
  - Why triggers custody
    - Gives RIA authority to withdraw funds or write checks to pay bills
  - Consider
    - Internal controls (e.g. account reconciliations)
    - Budget accordingly for surprise exam

- Trustee/Power of Attorney
  - Why triggers custody
    - Gives RIA control over client assets
  - Consider
    - Cost/benefit
    - Budget accordingly for surprise exam

Poll question coming up next

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Common Pitfalls and Considerations

- Possession of checks payable to a client or client's stock certificates
  - Why triggers custody
    - RIA "directly" holds client funds or securities
  - Consider
    - Internal controls
      - Must be returned promptly within 3 business days
      - Cannot simply be forwarded – MUST be returned to sender

- Access to client's usernames and passwords
  - Why triggers custody
    - Potentially gives RIA ability to withdraw or transfer funds
  - Consider
    - Review of account access capabilities
    - Firm prohibition on obtaining login credentials
      - Consider having client access during meetings

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COVID's Impact on the Custody Rule

- Question II.1
  - Inadvertent receipt of client securities
    - RIA not considered to have received such securities until able to access mail or deliveries at office location
- Question IV.7
  - Surprise exam logistical disruptions
    - Reasonable belief would be completed within 120-day deadline
      - Provides 45 day extension

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COVID's Impact on the Custody Rule

- Question VI.9
  - Distribution of pooled investment vehicle audited financial statements
    - Typically required within 120, 180 or 260 days depending upon tier level
    - Reasonable belief would be distributed within required timeframe
      - Appears to be covered under "certain unforeseeable circumstances" Q&A
- Question VII.4
  - Privately Offered Securities certificates with a qualified custodian
    - For duration of COVID closure, Division would not recommend enforcement if adviser does not maintain the certificates with a qualified custodian, if:
      - Physical certificate transfer/changes only with prior consent of issuer or holders
      - Ownership recorded on the books of the issuer
      - Physical certificates contain a legend restricting transfer
      - Physical certificates safeguarded by adviser
      - Adviser makes and keeps a record of the custodian's closure

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Summary

- Shared a brief reminder of Custody Rule requirements
- Took a look at a few common pitfalls and considerations of the Custody Rule
- Shared a few changes resulting from COVID

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Contact the Presenter

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Craig Evans is a director in Kreischer Miller's Investment Industry Group. Craig provides traditional audit and accounting, GIPS verifications, and composite examinations to clients in the investment industry. He also performs custody examinations in accordance with the Securities and Exchange Commission Rule 206(4)-2, assists firms in implementing the GIPS standards, and performs operational due diligence throughout the United States and Europe to assist investors in understanding the operational risk inherent in their investment managers' operations. Additionally, he has assisted entrepreneurs with starting investment firms and hedge funds. He works with a variety of clients, including investment management companies, funds, funds of funds, master feeders, broker-dealers, family offices, trust companies, and pension plans and their investments.

Break

Our next session will resume at 10:50am.

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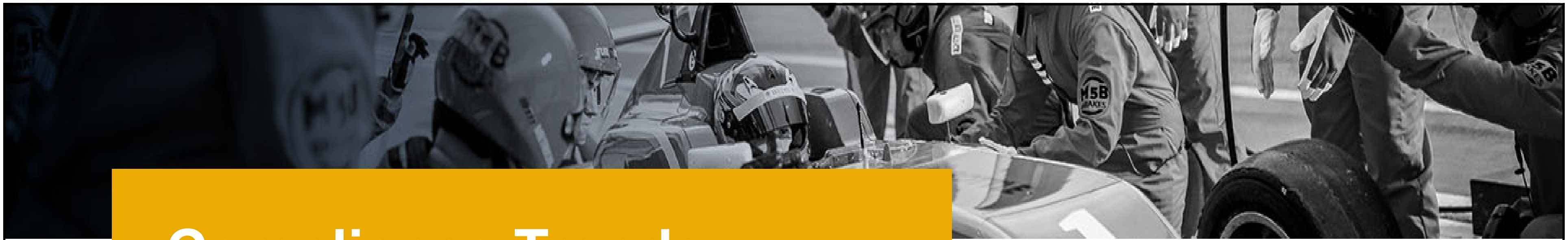
COMPLIANCE SERVICES

Kreischer Miller
Virtual Annual Investment Industry Seminar

SEC and Regulatory Update 2020

Todd Cipperman



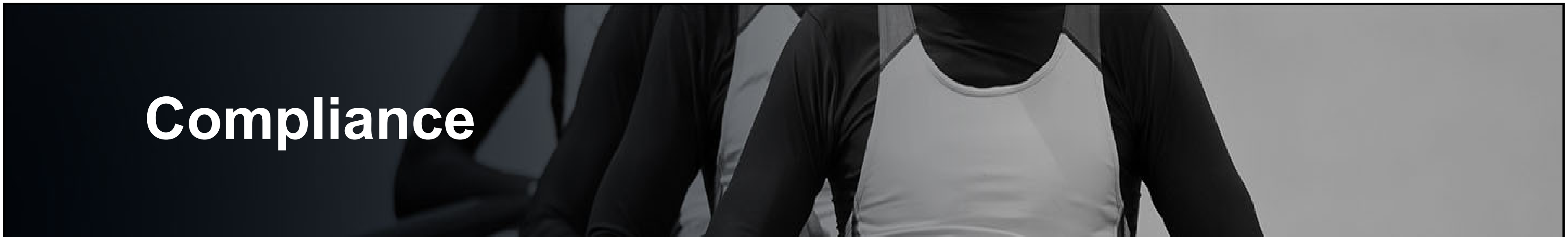
Compliance Trends

- The regulators continue to set enforcement records.
- The SEC has no mercy for weak compliance officers and programs.
- Following Reg BI, the regulators are attacking any form of self-dealing.
- Revenue sharing is nearing extinction.
- Service providers own liability for bad clients.
- New rules facilitate marketing and highlight risks.
- Registered funds are under the regulatory microscope.
- Private funds are cautiously expanding distribution.
- IT has become critical to asset management.
- FINRA needs enforcement to stay viable.

Enforcement

- SEC Record: $4.6 Billion
- Limited defenses
- C-suite cooperating
- DoJ and prison
- Fifth Amendment
- State securities regulators
- Supreme Court limitations

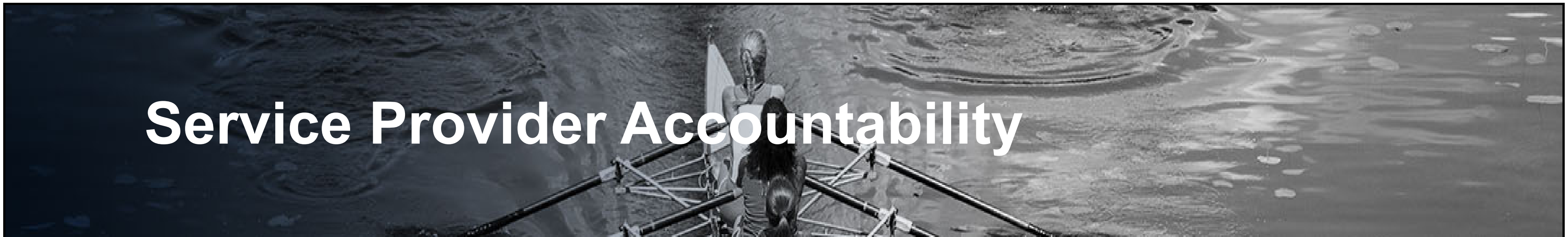
Compliance



- OCIE Priorities and COVID Risk Alert
- CCO resources
- Unqualified CCOs and dual-hats
- No procedures/no testing
- Email reviews
- Supervision
- Valuation
- Suspicious activity reporting
- Soft dollars
- Custody

Fiduciary Duty and Conflicts

- Regulation Best Interest
- Form CRS
- Self-Dealing
- Preferred clients
- Revenue Sharing
- Proxy Voting



Service Provider Accountability

- Administrators
- Auditors
- Outside counsel
- Custody banks
- Series Trusts

Marketing and Advertising

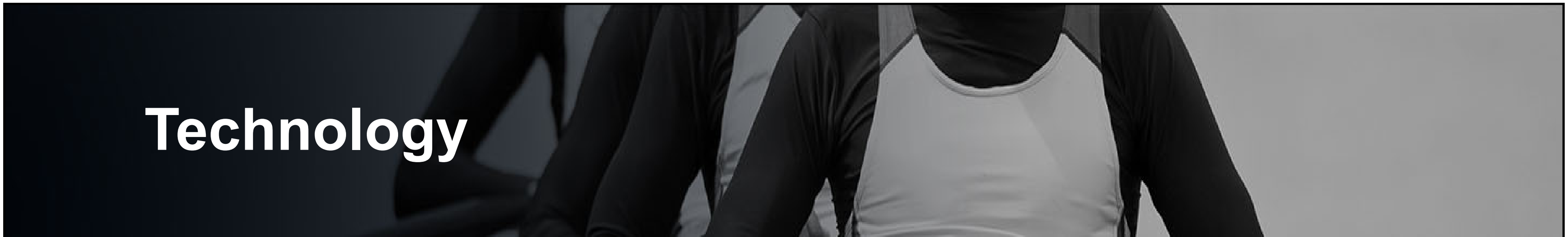
- New RIA marketing and advertising rule
- Over-stating returns and valuations
- Over-optimism
- Misrepresenting investment strategy, process
- Disclosure of disciplinary histories
- Financial problems
- Comparing returns
- Texts and social media

Registered Funds

- New Disclosure Regime
- Compliance failures
- Valuation
- BDCs and Closed-End Funds
- Board Practices

Private Funds

- Accredited investors
- Not qualified investors
- Illiquidity
- OCIE Alert
- LP Committees
- Compliance practices

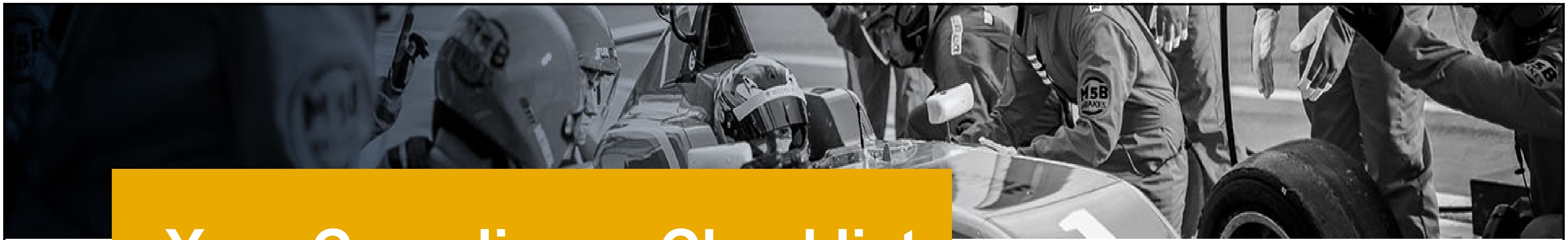


Technology

- Cybersecurity
- Credential Stuffing
- Crypto funds and ICOs
- Securities settlement
- IT and coding errors

FINRA

- Exams and enforcement
- Impact of financials
- Protection of senior investors
- Bad brokers
- Cash Sweep
- 529 recommendations



Your Compliance Checklist

- Do you have an internal reporting mechanism?
- Do you have D&O insurance?
- Do you have reliable outside counsel and compliance consultant?
- Is the CCO qualified and dedicated?
- Has there been testing of policies and procedures?
- What % of revenue is allocated to compliance?
- Have you done a conflicts inventory?
- Does your firm collect revenue sharing?
- Does the firm enforce/allow MFN clauses?
- Is Form ADV consistent with P/P and marketing?
- Does independent function calculate fees and performance?
- Is performance real or hypothetical/backtested?
- Are there portfolio risk parameters?
- Are the service providers reputable and independent?
- Are the independent directors really independent?
- How good is the technology?

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Thank you.
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Break

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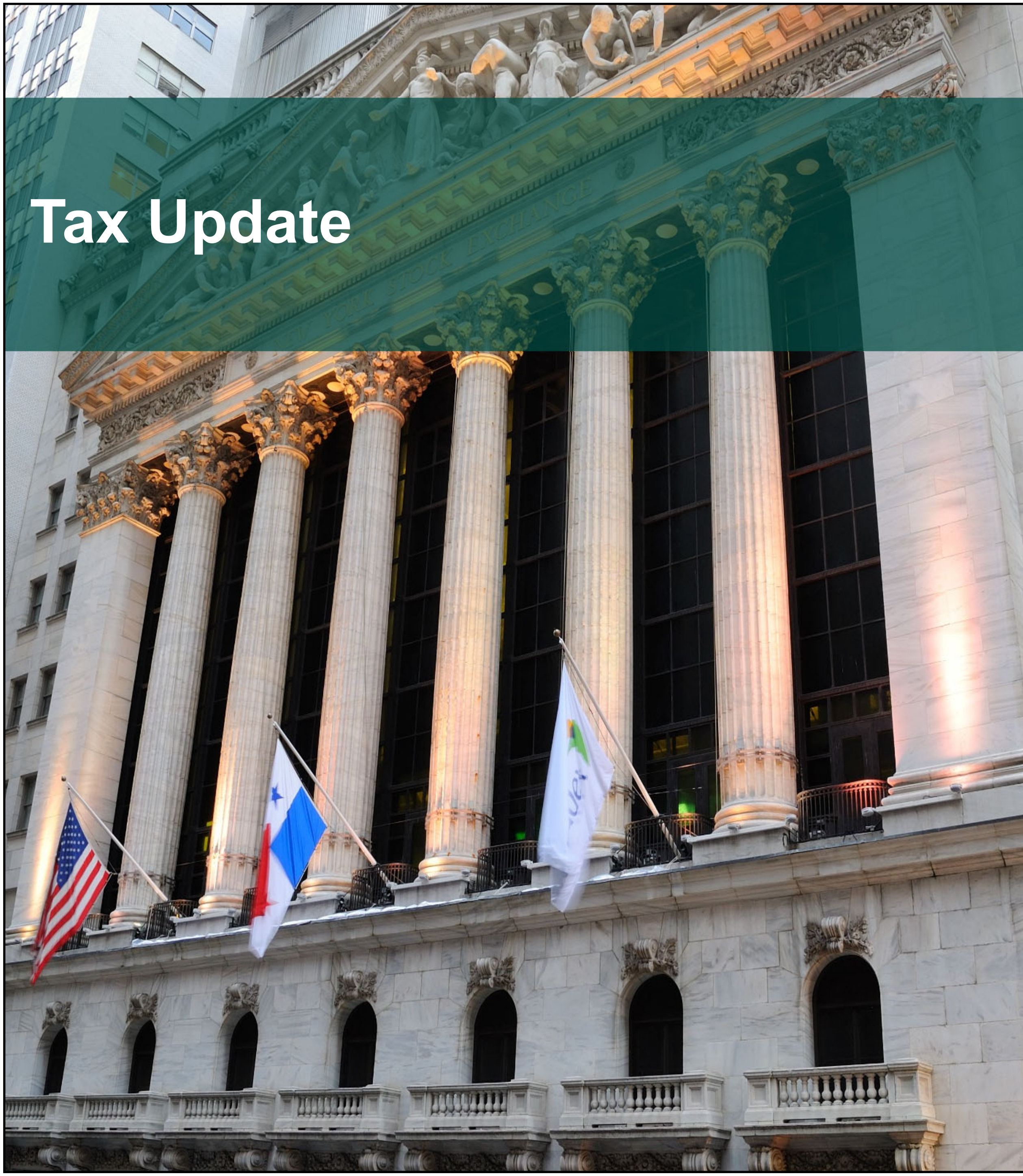
Tax Update



Richard J. Nelson
Director, Tax Strategies

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Agenda

1. Partnership K-1 Changes
2. COVID-19 Tax Provisions
3. Deductibility of Interest Expense
4. Excess Business Loss
5. Net Operating Loss Carryback
6. Biden’s Tax Proposals

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Partnership Form K-1 2020 Changes

- Schedule B New question 29
  - Regarding a foreign corporation's direct or indirect acquisition of substantially all of the properties constituting a trade or business of the partnership
- Codes for schedules K and K-1 revised and no longer listed on page 2 of Schedule K-1
- CARES Act new employee retention credit for qualified wages
- New form 15254 used to request a section 754 revocation
- Partners capital account analysis must be on a cash basis

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Partnership Form K-1 Changes 2020

- **Partner Capital Accounts**
  - Currently capital accounts could be reported on tax basis, GAAP basis, section 704(b) or other
  - For 2020 K-1's (2021 filing season) capital accounts must be reported on the tax basis

- IRS draft instructions dated **October 21, 2020** state capital accounts must be reported on a tax basis using the transactional approach

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Partnership Form K-1 Changes 2020

- **Transactional Approach**
  - Transactional approach is basically taking the items off of the K-1s
  - Takes into account other increases or decreases which includes nontaxable amounts that adjust basis
  - Does not take into account partner share of liabilities
  - Does not take into account partner specific adjustments

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Partnership Form K-1 Changes 2020

- How do you account for a partner's beginning balance?
  - Tax basis method, if used on the 2019 partnership tax return, or if your books and records are maintained on a tax basis
  - If not on a tax basis, may refigure a partner's beginning capital account using the following methods:
    - Tax Basis method
    - Modified outside basis method
    - Modified previously taxed capital method
    - Section 704(b) method

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Partnership Form K-1 Changes 2020

- Tax Basis Method
  - Generally the transactional approach. Go back through K-1's and calculate tax basis.
- Modified Outside Basis Method
  - Generally partners outside basis adjusted
  - Can rely on the adjusted tax basis information provided by the partners
- Modified Previously Taxed Capital Method
  - Takes into account cash a partner would receive on liquidation;
  - Increased by amount of tax loss allocated to partner following liquidation as adjusted; and
  - Decreased by amount of adjusted tax gain

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Partnership Form K-1 Changes 2020

- Section 704(b) Method
  - Capital account calculated under IRC Section 704(b) minus any built in gain or loss under IRC section 704(c)

- Link to draft 2020 Form 1065 instructions https://www.irs.gov/pub/irs-dft/i1065--dft.pdf

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Partnership Form K-1 Changes 2021

- **What do we get to look forward to in 2021 (2022 filing season)?**
  - New updates to Form 1065 are intended to provide greater clarity for partners on how to compute their U.S. income tax liability with respect to international tax matters, including how to compute deductions and credits
  - Applies if partnership has items of international tax relevance (generally foreign activities or foreign partners)
  - Would not affect domestic partnerships with no items of international tax relevance

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Partnership Form K-1 Changes 2021

Two new forms Schedule K-2 and Schedule K-3

- Schedule K-2, Partners' Distributive Share Items--International
  - Replaces portion of existing Schedule K lines 16(a) through 16(r)
  - Replaces 18 lines with 20 pages
  - Link to draft Schedule K-2 https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-2-Form-1065.pdf
- Schedule K-3, Partner's Share of Income, Deductions, Credits, etc.—International
  - Replaces portion of existing Schedule K-1, Part III, box 16 Foreign Transactions and box 20 Other Information
  - Replaces 2 boxes with 22 pages
  - Link to draft Schedule K-3 https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-3-Form-1065.pdf

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Partnership Form K-1 Changes 2021

16a Name of country or U.S. possession ▶

b Gross income from all sources 16b

c Gross income sourced at partner level 16c

Foreign gross income sourced at partnership level

d Reserved for future use ▶ e Foreign branch category . . . . . ▶ 16e

f Passive category ▶ g General category ▶ h Other (attach statement) ▶ 16h

Deductions allocated and apportioned at partner level

i Interest expense ▶ j Other . . . . ▶ 16j

Deductions allocated and apportioned at partnership level to foreign source income

k Reserved for future use ▶ l Foreign branch category . . . . . ▶ 16l

m Passive category ▶ n General category ▶ o Other (attach statement) ▶ 16o

p Total foreign taxes (check one): ▶ Paid Accrued 16p

q Reduction in taxes available for credit (attach statement) 16q

r Other foreign tax information (attach statement)

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Poll question coming up next

COVID-19 Provisions

Families First Coronavirus Response Act or FFCRA

- Refundable paid sick leave credit and the paid child care leave credit.
- If there are not sufficient payroll taxes to cover the cost of qualified sick and child care leave paid, employers will be able to file a request for an accelerated payment from the IRS.
- Applies to employers with fewer than 500 employees.
- Credits are claimed on Form 941. If greater than payroll taxes refundable.

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COVID-19 Provisions

Coronavirus Aid, Relief, and Economic Security Act or the CARES Act

- Paycheck Protection Program (PPP)
- Employer Payroll Tax Deferral
- Employee Retention Credit

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COVID-19 Provisions

Paycheck Protection Program (PPP)

- Forgivable government loans made to employers with less than 500 employees that were necessary due to COVID-19
- Loans are used to pay payroll, rent, utilities, certain interest, etc.

Two big issues right now:

- Forgiveness and deductibility of the PPP expenses
- Questionnaire for PPP loans $2 million or greater

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COVID-19 Provisions

- **Forgiveness and deductibility of the PPP expenses**
  - CARES Act – loan forgiveness does not result in taxable income. Expenses are deductible. Results in a double benefit.
  - IRS Notice 2020-32 forgiven amount is tax-exempt income and related expenses are nondeductible. IRS's position is basically we gave you free money, told you what you could spend it on, those expenses are not deductible
- **Questionnaire for PPP loans $2 million or greater**
  - Troubling insight into SBA's approach to its review
  - Borrowers need to prove "necessity certification"
  - Original guidance indicated standard was the future uncertainty that existed at the time the application was filed
  - Questionnaire seems to imply that financial results subsequent to the PPP loan application will be used to determine if the "necessity certification" was met

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COVID-19 Provisions

Employer Payroll Tax Deferral

- Delay payment of employers share of Social Security payroll taxes until December 31, 2020, with 50 percent due on December 31, 2021 and the remaining 50% due on December 31, 2022.
- Businesses have the ability to payback early.

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COVID-19 Provisions

Employer Retention Credit for Employers

- Provides a refundable payroll tax credit for 50% of qualified wages paid by eligible employers to certain employees during the COVID-19 crisis.
- The maximum amount of the eligible wages for the credit is $10,000 per employee.
- IRS is granted authority in the act to advance payments to eligible employers and waive applicable penalties for employers who do not deposit applicable payroll taxes in anticipation of receiving the credit.
- The credit applies to wages paid after March 13, 2020 and before January 1, 2021.

Eligible Employers

- Available to all for profit businesses as well as non-profits.
- Operations have been fully or partially suspended due to the concern about the spread of COVID-19 during any calendar quarter in 2020.

OR

- The business has a significant decline in gross receipts by more than 50% compared to the calendar quarter in the previous year.

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COVID-19 Provisions

Eligible employers (continued)

- If the employer has **more than 100 employees**, qualified wages include only wages paid to employees who are not working as a result of a COVID-19 related shutdown order or the significant decline in gross receipts.
- Employers with **100 or fewer employees**, qualified wages paid during the period when the operations were fully or partially suspended or during a quarter in which gross receipts have significantly declined are eligible for the credit, even if paid to an employee who is still working.
- Not available for wages paid under FFCRA or if you received a PPP loan.

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Deductibility of Interest Expense

- CARES Act increased the 163(j) interest limitation from 30% to 50% of adjusted taxable income
- With the exception of partnerships applies to tax years beginning in 2019 and 2020
- For partnerships increased limitation applies to tax years beginning in 2020
- Partners are permitted to treat 50% of their allocable share of a partnership's 2019 excess business interest expense ("EBIE") as paid or accrued in 2020 and such business interest expense is not subject to any further section 163(j) limitation at the partner level

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Excess Business Loss

- Flow through business losses capped at $250,000 single and $500,000 married filing joint
- CARES Act eliminated cap for tax years 2018-2020. Resumes in 2021
- Retroactive, revisit 2018 and 2019 returns to amend
- Keep in mind at-risk-rules and passive activity loss rules still apply

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Net Operating Loss Carrybacks

- Prior to CARES Act, for NOLs generated in taxable years ending after 12/31/2017:
    - No carryback of NOLs
    - Indefinite carryforward
    - Carryforward can only offset up to 80% of taxable income in carryover years

- CARES Act:
    - Permits NOLs from the 2018, 2019, and 2020 tax years to be carried back to the previous five tax years (beginning with the earliest year first)
    - Suspends the 80%-of-taxable-income limitation through the 2020 tax year
    - Taxpayers can waive the carryback period on their 2020 tax return

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Poll question coming up next

Biden's Tax Proposals

	Current Law TCJA	Biden
QBI Deduction	20% deduction for qualified S-Corps, Partnerships & individuals. Expires 2025.	Phase out the QBI deduction for filers with **taxable income over $400,000.**
Corporate Tax Rates	Flat tax of 21% and no AMT. No expiration.	Raise rate to 28% and reinstate AMT on book profits $100M or higher.
Individual Tax Rates	Top rate of 37% for individuals earning $518,400 or $622,050 MFJ. If QBI applicable rate is 29.6%.	Raise rate to 39.6% for taxable **income above $400,000.**
Capital Gains	The top tax rate is 20% for income over $441,450 for individuals and $496,600 for married filing jointly. There is an additional 3.8% net investment income tax.	Biden would eliminate breaks for capital gains and dividends for **income above $1 million**. Instead, taxed at ordinary rates.
Payroll Taxes	The 12.4% payroll tax is divided evenly between employers and employees and applies to the first $137,700 of an individual's income.	Biden would maintain the 12.4% tax split between employers and employees and keep the $137,700 cap but would institute the tax on **earned income above $400,000**. The gap between the two wage levels would gradually close with annual inflationary increases.

Biden's Tax Proposals

	Current Law TCJA	Biden
Estate Tax Exemption and Rate	$10,580,000 exemption per person and a 40% tax rate.	$3,500,000 exemption and a 45% tax rate.
Gift Tax	Same as the estate tax exemption.	$1,000,000 exemption and a 45% rate.
Step up in basis upon death	Yes.	Eliminated.

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Thank You!

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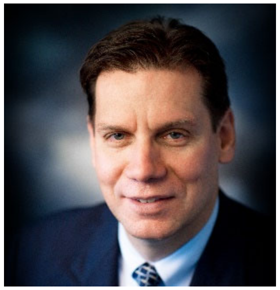

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Rich Nelson has extensive experience providing domestic and international tax planning and services to a variety of middle market companies and entrepreneurial businesses in a number of industries including manufacturing, distribution, real estate, financial, and professional services. He also has significant experience and expertise with high-net-worth individuals, investment companies and pass-through entities and has been involved in federal, state, and local tax audits, settlements, and appeals.

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