

Chapter 1

Overview of the Investment Company Industry

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2019, but becoming effective on or prior to December 31, 2019, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

© Update 1-1 Accounting and Reporting: Credit Losses

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities (PBEs) that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

Note: At the July 17, 2019, board meeting, FASB adopted a two-bucket approach to stagger effective dates for major standards. Bucket one includes SEC filers (as defined in generally accepted auditing principles [GAAP]), excluding smaller reporting companies (SRCs) as currently defined by the SEC. Bucket two makes up all other entities, which includes the following:

- All other PBEs, including SRCs
- Private companies
- All not-for-profit organizations, including not-for-profit entities that have issues, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- All employee benefit plans, including employee benefit plans that file financial statements with the SEC

The board decided that FASB ASU No. 2016-13 will be effective for PBEs that are SEC Filers, excluding SRCs as currently defined by the SEC, for fiscal years beginning after December 15, 2019,

and interim periods within those fiscal years. The determination of whether an entity is an SRC will be based on an entity's most recent assessment in accordance with SEC regulations. For all other entities, the board decided that FASB ASU No. 2016-13 will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early adoption will continue to be permitted; that is, early adoption is allowed for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (that is, effective January 1, 2019, for calendar-year-end companies).

The FASB board's tentative decisions can be located under the "Meetings" page at www.fasb.org. FASB notes that all of the conclusions reported are tentative and may be changed at future board meetings. Decisions become final only after a formal written ballot to issue an ASU or a Statement of Financial Accounting Concepts.

ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities.

For assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. This also changed guidance in FASB ASC 325-40, which is related to initial and subsequent measurement.

Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on ASU No. 2016-13, see appendix J, "Accounting for Financial Instruments," of this guide.

Introduction

1.01 The investment company industry is highly specialized; intensely competitive; and may be subject to specific governmental regulation, special tax treatment, and public scrutiny. Accordingly, before starting an engagement to audit an investment company's financial statements, an auditor should become familiar with the entity's business; its organization, structure, and operating characteristics and the industry's terminology; legislation; and, if applicable, relevant securities and income tax laws and regulations. This chapter provides an introductory review of these topics.

Guide Application

1.02 Auditing. The auditing procedures discussed in this guide apply to most investment companies.¹ Fundamental considerations associated with the planning and execution of investment company financial statement audits are included in chapter 11, "General Auditing Considerations," of this guide, while auditor report considerations are provided in chapter 12, "Independent Auditor's Reports and Client Representations." When applicable, audit considerations directly associated with certain specific accounting principles are included within the respective chapters of this guide where the specific accounting principles are discussed.

1.03 Accounting. The accounting principles discussed in this guide apply to all investment companies within the scope of FASB ASC 946 (as discussed in the following section of this chapter).

1.04 Consistent with FASB ASC 946-10-15-3, this guide does not apply to real estate investment trusts, which have some of the attributes of investment companies but are scoped out of FASB ASC 946.

Investment Companies Defined — Scope of FASB ASC 946

1.05 FASB ASC 946-10-15-5 requires an entity that is not regulated under the Investment Company Act of 1940 (1940 Act) to perform an assessment to determine whether it is an *investment company* for accounting purposes, and is, therefore, within the scope of the industry-specific guidance in FASB ASC 946.

1.06 An entity regulated under the 1940 Act is an investment company for accounting purposes, pursuant to FASB ASC 946-10-15-4.

1.07 Paragraphs 6–7 of FASB ASC 946-10-15 identify characteristics of an investment company. Entities that are not regulated under the 1940 Act are required to meet certain fundamental characteristics to be considered investment companies, and are also required to be assessed for other typical characteristics of investment companies. An entity's purpose and design should be considered when conducting the assessment. An entity that does not have the fundamental characteristics is not an investment company. However, failing to meet one or more of the typical characteristics does not necessarily preclude an entity from being an investment company. If an entity does not possess one or more of the typical characteristics, judgment should be applied and a determination made, considering all facts and circumstances, on whether the entity's activities are consistent (or are not consistent) with those of an investment company.

1.08 Based on FASB ASC 946-10-15-6, an entity must have the following fundamental characteristics to be an investment company:

¹ The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of nonissuers. See the section "Applicability of Generally Accepted Auditing Standards and PCAOB Standards" of the preface to this guide for a discussion of the definitions of issuer and nonissuer as used throughout this guide. Further considerations for audits of issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. PCAOB guidance included in an AICPA Guide has not been reviewed, approved, disapproved, or otherwise acted upon by the PCAOB and has no official or authoritative status.

- a. It is an entity that does both of the following:
 - i. Obtains funds from one or more investors and provides the investor(s) with investment management services
 - ii. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both
- b. The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

In addition, an entity should assess whether it has the following typical characteristics of an investment company, as identified in FASB ASC 946-10-15-7:

- a. More than one investment
- b. More than one investor
- c. Investors that are not related parties of the parent entity (if there is a parent) or the investment manager
- d. Ownership interests in the form of equity or partnership interests
- e. Substantially all of its investments are managed on a fair value basis

1.09 Technical Questions and Answers (Q&A) section 6910.36, "Determining Whether Loan Origination Is a Substantive Activity When Assessing Whether an Entity Is an Investment Company"² discusses how an entity determines whether loan origination activity represents a substantive activity that precludes the entity from qualifying as an investment company under FASB ASC 946-10-15-6 when such loan originations to third parties are performed for the purposes of maximizing an entity's returns from capital appreciation, investment income, or both.

1.10 In performing the assessment, Q&A section 6910.36 states that entity should consider its design, business purpose (see paragraphs 4–7 of FASB ASC 946-10-55), and the reason for performing the activities (see FASB ASC 946-10-55-10), including how the entity is marketed and presented to current and potential investors. If an entity believes it is an investment company under FASB ASC 946 the entity's design, business purpose, and how it holds itself out to investors should be consistent with those of an investment company.

1.11 Determining whether loan origination activity represents a substantive activity may require significant judgment. Loan origination would generally be considered inconsistent with the business purpose of capital appreciation, investment income, or both (investing income). Significance of the income generated from the entity's origination and syndication of loans as compared to the income generated through capital appreciation, investment income, or both, is an important factor for entities to consider. FASB ASC 946-10-55-4 indicates

² *Technical Questions and Answers* is not a source of established authoritative accounting principles as described in the FASB *Accounting Standards Codification*[®], the authoritative source of U.S. generally accepted accounting principles for nongovernmental entities. This nonauthoritative material is based on selected practice matters identified by the staff of the AICPA Technical Hotline and various other bodies within the AICPA and has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

All Q&A sections can be found in *Technical Questions and Answers*.

that an investment company should have no substantive activities other than its investing activities and should not have significant assets or liabilities other than those relating to investing activities. The evaluation of loan origination activities generally would include a quantitative and qualitative assessment of the significance of those activities relative to the entity's investing activities. Often, the entity's business strategy with respect to originating loans (for example, if the entity originates and holds the loans versus originating and selling the loans) would correspond to the quantitative significance of loan origination income relative to investing income.

1.12 The fee income generated as part of loan origination activities relative to total income represents an important factor for entities to consider. An entity would generally also perform a qualitative analysis in determining whether the loan origination represents a substantive activity of the entity. Appendix A, "Factors to Consider in Determining Whether Loan Origination Represents a Substantive Activity of the Entity," to Q&A section 6910.36 provides examples of when factors may be more or less indicative of an investment company.

1.13 Q&A section 6910.36 concludes in addressing the requirements of FASB ASC 946-10-25-1 and states that a change in the level of loan origination activity or holding period for self-originated loans that would affect its quantitative analysis, as well as changes to the qualitative factors, may indicate that the purpose and design of the entity have changed.

1.14 Readers should consider and utilize the related implementation guidance in FASB ASC 946-10-55, which is an integral part of assessing investment company status and provides additional guidance for that assessment.

1.15 The aforementioned definition of an investment company has similarities to the legal definition of an investment company in federal securities laws. Securities laws explain that typically, an investment company sells its capital shares to investors; invests the proceeds, mostly in securities, to achieve its investment objectives; and distributes to its shareholders the net income earned on its investments and net gains realized on the sale of its investments.

1.16 Paragraph 1 of FASB ASC 946-10-25 states that an initial determination of whether an entity is an investment company should be made upon formation of the entity; afterwards, an entity should reassess whether it is or is not an investment company only if there is a subsequent change in the purpose and design of the entity or if the entity is no longer regulated under the 1940 Act. For information about change in status, readers should review FASB ASC 946-10-25 and the related implementation guidance and illustrative examples in FASB ASC 946-10-55.

Types of Investment Companies

1.17 Several types of entities may meet the aforementioned investment company scope criteria, including but not limited to the following:

- Management investment companies registered under or otherwise regulated by the 1940 Act
- Unit investment trusts (UITs)
- Common (collective) trust funds
- Investment partnerships

- Special purpose funds
- Venture capital investment companies, private equity funds, hedge funds
- Certain separate accounts of life insurance companies
- Offshore funds

See the "Definition and Classification" section of this chapter for further discussion of these and other types of entities.

1.18 Management investment companies may include

- open-end funds (usually known as mutual funds), including exchange-traded funds (ETFs), and
- closed-end funds, including
 - small business investment companies (SBICs) and
 - business development companies (BDCs).

1.19 Investment companies may be organized under various legal entity forms, including corporations (in the case of mutual funds, under the laws of certain states that authorize the issuance of common shares redeemable on demand of individual shareholders); common law trusts (sometimes called business trusts); limited partnerships, limited liability investment partnerships and companies; and other more specialized entities such as separate accounts of insurance companies that are not in themselves entities at all except in the technical definition of the 1940 Act.

1.20 Mutual funds and closed-end investment companies registered with the SEC under the 1940 Act are common forms of investment companies and are required to follow many rules and regulations prescribed by the SEC. These rules and regulations are discussed within the "Regulation" section of this chapter and elsewhere throughout this guide.

History

1.21 One of the first documented concepts of investment companies originated in England in 1868 with the formation of the Foreign & Colonial Government Trust. Its purpose was to provide investors of moderate means with the same advantages as those of more affluent investors (that is, to diminish risk by spreading investments over many different securities). Massachusetts Investors Trust, the first mutual fund, was organized in 1924.

1.22 The investment company industry has changed considerably since its origin and has attracted insurance companies, brokerage firms, conglomerates, banks, and others as sponsors to perform advisory or distribution services. Initially, the industry was characterized by one- or two-person managements, relatively simple investment techniques, and rudimentary sales practices. Today, investment techniques are more sophisticated, and selling practices are more creative and aggressive. For example, in the 1970s, tax-exempt and money market funds came into use; in the 1980s, funds entered foreign markets; in the 1990s, funds entered the derivative security markets, which necessitated new investment expertise and increasingly sophisticated data processing capability; and in the 2000s, funds expanded their derivative activity and invested in such instruments as asset-backed securities and private placement equities, which

can be difficult to value. Fund organization structures have become more complex with the introduction of multiple class funds, series funds, master-feeder funds, funds of funds, and exchange traded funds. These funds potentially provide greater flexibility to multiple markets such as retail customers (who may be charged a front-end load, level load, or contingent deferred sales load as described in chapter 4, "Capital Accounts," of this guide) and institutions.

Definition and Classification

1.23 The term *mutual fund* is the popular name for an open-end management investment company (open-end company) registered under or otherwise regulated by the 1940 Act.³ An open-end company stands ready to redeem its outstanding shares, based on net asset value, at any time. Shares of an open-end company, other than open-end companies organized as ETFs (discussed in paragraph 1.29), typically are not traded. Most open-end companies offer their shares for sale to the public continuously, although they are not required to do so. The price at which the shares of mutual funds are sold is determined by dividing each fund's net assets, generally stated at fair value, by the number of its shares outstanding; the resulting net asset value per share may be increased by a sales charge, called a *load*, which provides commissions to the underwriter and dealer. Funds whose shares are sold at net asset value without a sales charge or that have a 12b-1 plan (see paragraph 8.13 of this guide) that charges not more than 0.25% of average net assets per year (that is, 25 basis points) are known as *no-load funds*. Some funds or classes of shares of funds may charge contingent deferred sales loads or fees when shares are redeemed.⁴

1.24 Unlike an open-end company, a closed-end management investment company generally does not offer to redeem its outstanding capital shares on a daily basis. However, some closed-end funds do make periodic repurchase offers for their outstanding shares. Those closed-end funds that repurchase their shares on a periodic basis at stated intervals are commonly known as interval funds. The outstanding shares of closed-end funds that are not considered to be interval funds are usually exchange listed and traded on the open market at prices that generally differ from net asset value per share, although market prices are influenced by net asset value per share reported regularly in financial publications. Most closed-end companies offer their shares to the public in discrete offerings, although some closed-end funds offer their shares on a continuous basis. Closed-end investment companies may offer their shareholders

³ Section 4 of the Investment Company Act of 1940 (1940 Act) uses the term *management company* to describe investment companies that are not face-amount certificate companies or unit investment trusts. For clarity of usage, the term *management investment company* is used in this guide.

⁴ In October 2016, the SEC issued Release Nos. 33-10233; IC-32315, *Investment Company Liquidity Risk Management Programs* which adopted new rules, rule amendments, and a new form to promote effective liquidity risk management and enhance disclosure regarding fund liquidity and redemption practices. In June 2018, the SEC issued Release No. IC-33142, *Investment Company Liquidity Disclosure*, which adopts a new requirement that funds disclose information about the operation and effectiveness of their liquidity risk management program in their reports to shareholders. Readers are encouraged to consult the full text of the release for details.

Also in October 2016, the SEC issued Release Nos. 33-10234; IC-32316; *Investment Company Swing Pricing*. The final rule adopts amendments to Rule 22c-1 under the Investment Company Act to permit a registered open-end management investment company (except a money market fund or exchange-traded fund), under certain circumstances, to use swing pricing. The final rule also adopts amendments to Rule 31a-2 to require funds to preserve certain records related to swing pricing. In addition, the use of swing pricing is being addressed in amendments to Form N-1A and Regulation S-X, and a new item in Form N-CEN. The effective date is November 19, 2018.

a dividend reinvestment plan. Investments are valued, and net asset value per share is calculated, using the same method as mutual funds.

1.25 Investment companies are grouped according to their primary investment objectives (for example, income, growth, index, balanced, money market, tax exempt, alternative, or combinations of those groups). The kinds of investments made by those funds reflect their stated objectives. For example, growth funds invest almost exclusively in securities with appreciation potential, whereas money market funds invest solely in short-term debt instruments. In accordance with Rule 35d-1 of the 1940 Act, an investment company registered under the 1940 Act is required to invest at least 80% of its assets in the type of investment suggested by its name.

1.26 Investment companies registered with the SEC under the 1940 Act are classified as diversified companies or nondiversified companies.⁵ According to the 1940 Act, shareholder approval is required for an investment company registered as diversified to become nondiversified but not for a company registered as nondiversified to become diversified. If a nondiversified company operates as a diversified company, it may change back to a nondiversified company within three years of the change to a diversified company without shareholder approval, provided that its registration statement has not been amended.⁶

1.27 Closed-end management investment companies include, but are not limited to, SBICs and BDCs. An *SBIC* is an entity that provides equity capital, long-term loans, or both to small businesses; is licensed by the Small Business Administration (SBA) under the Small Business Investment Act of 1958; and may also be registered under the 1940 Act or be a subsidiary of another company. It may obtain financing from the federal government in the form of subordinated debentures based on the amount of its equity capital and the amount of its funds invested in venture-type investments. A *BDC* is an entity that invests in small, upcoming businesses and often makes available significant managerial assistance to portfolio companies. Amendments to the 1940 Act, which were enacted in the 1980s, provided for the formation of BDCs under specified regulations in Sections 54–65, which allow greater flexibility and exemption from many 1940 Act provisions applicable to registered investment companies (for example, greater flexibility when dealing with their portfolio companies, issuing securities, and compensating their managers). In addition, BDCs are not required to register as investment companies under the 1940 Act. They are, however, required to register their securities under the Securities Exchange Act of 1934 (the 1934 Act). BDCs are generally publicly traded investment vehicles. (These closed-end companies are discussed in appendix C, "Venture Capital, Business Development Companies, and Small Business Investment Companies," of this guide.)

1.28 A UIT is an investment company organized under a trust indenture or similar instrument and registered under the 1940 Act. A UIT has no board of directors or trustees and issues only redeemable units, each representing

⁵ As defined in Section 5(b) of the 1940 Act, a *diversified company* is defined as follows: at least 75% of the value of its total assets is represented by cash and cash items (including receivables), government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of such management company and to not more than 10% of the outstanding voting securities of such issuer. A *nondiversified company* means any management company other than a diversified company.

⁶ Rule 13a-1 of the 1940 Act.

an undivided interest in a group of securities (such as corporate debentures or municipal debt) or a unit of specified securities or securities of a single issuer (such as shares of a particular mutual fund). UITs that provide a formal method of accumulating mutual fund shares under a periodic payment plan or a single payment plan are commonly known as contractual plans.

1.29 An ETF is a type of open-end management investment company (or, less frequently, a UIT). Currently, ETFs are required to obtain exemptive relief from the SEC from various rules and regulations under the 1940 Act. ETF shares are listed on a stock exchange and trade throughout the day at market prices, in a manner similar to a closed-end fund. Individual ETF shares are not redeemable on a daily basis directly from the fund. Rather, ETFs issue and redeem shares either in-kind or in cash in institutional lots, typically 25,000 shares or more (referred to as *creation units*) to authorized participants. The ability to issue and redeem creation units of ETF shares tends to act as an arbitrage mechanism which can help maintain the ETF's trading price at, or close to, the net asset value per share of the underlying portfolio, although there is no guarantee that the trading price will approximate net asset value at any given time. Although the majority of ETFs seek to replicate various stock and bond indices, at the end of 2014, the SEC permitted the offering of such a structure called an exchange-traded managed fund.

1.30 The terms *common and collective trusts* (CCTs) are general, nonlegal terms used to describe unregistered investment pools that are not available to the general investing public. CCTs are sponsored by a bank or trust company for the collective investment of assets from institutional trust accounts and pension plans. Many bank-sponsored CCTs are subject to regulations issued by the Office of the Comptroller of the Currency. See appendix B, "Common or Collective Trusts," for additional discussion.

1.31 The term *hedge fund* is a general, nonlegal term used to describe private, unregistered investment pools that are not widely available to the public and have traditionally been limited to accredited investors, qualified purchasers, and large institutions. Hedge funds likely originated as private investment funds that combined long and short equity positions within a single leveraged investment portfolio. Currently, hedge funds employ a wide variety of trading strategies and techniques to generate financial returns, and may or may not utilize complex derivative instruments or leverage in the investment portfolio. Hedge funds are not mutual funds and, as such, are not subject to certain regulations (such as diversification and leverage limits) that apply to mutual funds for the protection of their investors.

1.32 The term *nonregistered investment partnership* is a general, nonlegal term used to describe private investment pools (commonly referred to as hedge funds or private equity funds) that are exempt from SEC registration under the 1940 Act. Such investment vehicles can be organized using various unitized or nonunitized legal forms including limited partnerships, limited liability companies, limited liability partnerships, limited duration companies, and offshore investment companies with similar characteristics. Nonregistered investment partnerships may be commodity pools subject to regulation under the Commodity Exchange Act of 1974. For example, nonregistered investment vehicles organized as limited partnerships are governed by a limited partnership agreement and their partners are taxed individually on their allocated share of the partnership's taxable income. The majority of the capital in a partnership is owned by its limited partners. The general partner, who may have little to

no investment in the partnership, is responsible for the partnership's day-to-day administration. Nonregistered investment partnerships may be unitized or nonunitized.

1.33 The term *private equity fund* is a general, nonlegal term used to describe private, unregistered investment pools that are not widely available to the public and have traditionally been limited to accredited investors, qualified purchasers, and large institutions. Private equity funds typically seek to generate returns through longer term appreciation from investments in privately held and nonlisted publicly traded companies (collectively "private companies"). Private equity funds often obtain equity interests (controlling or significant minority interests) and, to a lesser extent, debt of private companies that allow for active involvement in investee operations, restructuring, and merger and acquisition activity, through board oversight positions. A private equity fund is typically a limited partnership or limited liability company with a fixed term, generally of 10 years (often with annual extensions). At inception, investors make an unfunded commitment to the fund, which is then drawn upon over the term of the fund.

1.34 A *venture capital investment company* is a general, nonlegal term used to describe a closed-end company whose primary investment objective is capital growth and whose capital is invested at above-average risk to form or develop companies with new ideas, products, or processes. It is generally not registered under the 1940 Act.

1.35 A *commodity pool* is an investment vehicle that is organized as a limited partnership, limited liability company, trust, corporation, or similar form of enterprise, and structured so that the funds of investors are combined into a single investment vehicle for the purpose of trading in commodity interests, which include futures contracts, options on futures contracts, and swaps. Many pools also trade other financial instruments, including foreign currencies, forward contracts and securities. Generally, a commodity pool is legally structured so that an investor, other than the general partner, cannot lose more than his or her investment and so that the pool itself is not subject to U.S. tax. A commodity pool is not mutually exclusive from the types of investment companies summarized within this chapter section; rather, any type of investment company that meets certain limits may also be considered a commodity pool. A commodity pool is organized and administered by one or more commodity pool operators (CPOs) and those CPOs may use commodity trading advisers (CTAs) to execute commodity trading strategies. See regulatory considerations associated with commodity pools in paragraphs 1.65–.66.

1.36 For descriptions and discussion regarding funds of funds, master-feeder funds, and multiple-class structures, see chapter 5, "Complex Capital Structures," of this guide.

Organizations Providing Services to Investment Companies

1.37 Most investment companies have no employees; however, registered investment companies are required to have a chief compliance officer who may or may not be compensated wholly or partially by the investment company. Portfolio management, recording of shares, administration, recordkeeping, distribution, and custodianship are examples of significant activities that are

performed for such investment companies. These activities generally are performed by organizations other than the investment company (for example, investment adviser [manager or general partner], transfer agent, administrator, recordkeeping agent, principal underwriter [distributor], and a custodian). The distributor is often a separate division or subsidiary company of the investment adviser or administrator. The use of agents to perform accounting or other administrative functions does not relieve the investment company's officers and directors or trustees (or the equivalent) of the responsibility for overseeing the maintenance and reliability of the accounting records and the fairness of financial reports. Management investment companies are governed by a board of directors or trustees that has certain responsibilities, as dictated by the 1940 Act. Many nonregistered investment companies have boards of directors or trustees which have similar responsibilities to those of 1940 Act management investment companies. The board's responsibilities are highlighted throughout this guide.

The Investment Adviser

1.38 The investment adviser or manager generally provides investment advice, research services, and certain administrative services under a contract, commonly referred to as the investment advisory agreement. The investment advisory agreement provides for an annual fee, which is often based on a specified percentage of net assets. The fee schedules of many contracts provide for reduced percentage rates on net assets in excess of specified amounts (break points). Other contracts may have performance fee schedules that provide for a basic fee percentage plus a bonus, or less a penalty, based on a comparison of the investment company's performance to a market index specified in the investment advisory agreement (sometimes referred to as a "fulcrum fee"). If a performance fee schedule is used for an investment company registered under the 1940 Act, the potential bonus for performance above that of the index must be matched by an equivalent potential penalty for performance below that of the index.⁷ Such incentive fee arrangements need not be symmetrical if an investment company is not registered with the SEC for sale to the general public. Occasionally, the investment advisory fee may be based wholly or partly on the investment income earned by the fund. Administrative services may be provided by an entity other than the investment adviser under a separate administrative agreement.

1.39 The investment advisory agreement for a registered investment company generally should be approved by the initial shareholder (usually the investment adviser) and thereafter by a majority of the directors or trustees who are not interested persons, as defined by the 1940 Act. Continuation of the contract beyond two years requires annual approval by a vote, cast in person (usually construed to mean face to face, not by telephone), of (a) the board of directors or trustees or a majority of the outstanding shares and (b) directors or trustees who are not interested persons.⁸ Significant modifications to the investment advisory agreement after a registered investment company begins its operations would be subject to approval by the board of directors or trustees and often are also subject to approval by a vote of a majority of the fund's outstanding shares.

⁷ SEC Final Rule Release No. 7484 under the 1940 Act.

⁸ Sections 2(a)(19), 15(a), and 15(c) of the 1940 Act.

The Distributor

1.40 The distributor, also known as an underwriter of the fund's shares, acts as an agent or a principal and sells the fund's shares as a wholesaler through independent dealers or as a retailer through its own sales network. Shares are sold at net asset value, and a sales charge may be added for the underwriter's and dealers' commissions. Other common commission structures use Rule 12b-1 fees or contingent deferred sales loads. The amount of sales charges, including asset-based sales charges such as Rule 12b-1 fees and contingent deferred sales loads, is regulated by the Financial Industry Regulatory Authority. Additionally, Rule 22d-1 of the 1940 Act permits funds to set variable sales charges. A no-load fund may or may not have a distributor.

1.41 Requirements for approval of a distributor's contract by the registered investment company's board of directors or trustees are similar to those described for the investment adviser. If the distributor's contract is approved by the board, shareholder approval is not necessary. Many registered investment companies adopt distribution plans under Rule 12b-1 permitting the use of fund assets to pay for distribution expenses. One special requirement of Rule 12b-1 is that members of the board of directors or trustees who are not interested persons, as defined, must approve the plan each year, and the plan can be terminated without penalty on 60 days' notice.

The Custodian

1.42 Custody of the fund's cash and portfolio securities is usually entrusted to a bank or, less frequently, a member of a national securities exchange that is responsible for their receipt, delivery, and safekeeping. Custody arrangements and the auditor's responsibilities are discussed in detail in chapters 2, "Investment Accounts," and 12 of this guide.

The Transfer Agent

1.43 The fund's transfer agent, which may be a bank or a private company, issues, transfers, redeems, and accounts for the fund's capital shares. Sometimes the investment adviser, distributor, or another related party performs those functions. Section 17A of the 1934 Act requires certain transfer agents to register with the SEC and prescribes standards of performance concerning their duties.

The Administrator

1.44 The fund may engage an administrator that may or may not be independent of the investment adviser. Occasionally, if the investment adviser is engaged as the administrator, the investment adviser will engage an independent sub-administrator. In all of these instances, the administrator is responsible for performing or overseeing administrative tasks such as the filing of reports with the SEC and the IRS, the registering of fund shares, corresponding with shareholders, and determining the fund's compliance with various restrictions. The administrator may also maintain the fund's books and records, assist with calculating the net asset value and fund performance on a periodic basis, and assist with certain aspects of investment valuation, among other tasks. Although others may assist with calculating the fair value of investments, ultimate responsibility for such fair values rests with fund management.

Regulation

1.45 Generally, an investment company is required to register with the SEC under the 1940 Act if one of the following is true:⁹

- a. Its outstanding securities, other than short-term paper, are beneficially owned by more than 100 persons (including the number of beneficial security holders of a company owning 10% or more of the voting securities of the investment company).¹⁰
- b. It is offering or proposing to offer its securities to the public.

1.46 The Division of Investment Management of the SEC is responsible for reviewing such registrations. The investment company's shares are also registered under the Securities Act of 1933 (the 1933 Act) and with various state securities commissions before being offered for sale to the public. After registering with the SEC under the 1940 Act or both the 1940 Act and the 1933 Act, the company must report periodically to its shareholders and the SEC. Accordingly, auditors of investment companies should be familiar with the following acts:

- a. The 1933 Act, often referred to as the disclosure act, regulates the contents of prospectuses and similar documents and is intended to assure that potential investors receive adequate information to make reasonably informed investment decisions.
- b. The 1934 Act regulates securities brokers and dealers, stock exchanges, and the trading of securities in the securities markets. The distributor must register as a broker-dealer under the act. The act also governs disclosures in proxy materials used to solicit the votes of shareholders of an investment company, as does the 1940 Act. According to Section 17(A)(c) of the 1934 Act, if the fund's transfer agent is not a bank, it should be registered under the 1934 Act.
- c. The 1940 Act regulates the investment company industry and provides rules and regulations that govern the fiduciary duties and other responsibilities of an investment company's management. BDCs elect to be regulated under certain sections of this act.
- d. The Investment Advisers Act of 1940 requires persons paid to render investment advice to individuals or institutions, including investment companies, to register and regulates their conduct and contracts.
- e. The Small Business Investment Act of 1958 authorizes the SBA to provide government funds under regulated conditions to SBICs licensed under this act.
- f. The Small Business Investment Incentive Act of 1980 amended the 1940 Act by, among other things, allowing certain closed-end companies to elect to be regulated as BDCs under less rigorous Sections 54–65 of the 1940 Act.

⁹ Otherwise, the company is exempted from registration by Section 3(c)(1) of the 1940 Act.

¹⁰ Section 3(c)(7) of the 1940 Act allows certain companies to have more than 100 persons if those persons are qualified purchasers.

Summary of Relevant SEC Registration and Reporting Forms

© Update 1-2 *Regulatory: Investment Company Reporting Modernization*

In October 2016, the SEC issued Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*. Intended to modernize the reporting and disclosure of information by registered investment companies, the final guidance adopts new rules and forms and amends existing rules and forms. The compliance dates vary. The final rule is summarized in the following paragraphs.

Adoption of New Form N-PORT, Rescission of Form N-Q, and Amendments to Form N-CSR. New Form N-PORT, *Monthly Portfolio Investments Report*, will require certain registered investment companies to report information about monthly portfolio holdings to the SEC in a structured data format. Form N-PORT applies to all registered management investment companies, other than money market funds and SBICs. Currently, management investment companies other than SBICs are required to report their complete portfolio holdings to the SEC on a quarterly basis on Forms N-Q and N-CSR. Form N-Q is being rescinded to avoid unnecessary duplication of information reported in new Form N-PORT. The certifications by principal executive and financial officers of a fund (relating to the accuracy of information and internal control over financial reporting) that would otherwise be eliminated when Form N-Q is rescinded will be required by Form N-CSR under the amendments. The requirements will be amended to cover the most recent fiscal half, rather than the most recent fiscal quarter. The compliance dates are tiered based on asset size. For large fund groups, temporary rule 30b1-9(T), issued in December 2017, delays the previous EDGAR submission requirements associated with Form N-PORT until April 2019. As a result, funds in larger fund groups that previously would have been required to submit their first reports on Form N-PORT on EDGAR for the period ending June 30, 2018 (no later than July 30, 2018) will now be required to submit their first reports on EDGAR by April 30, 2019. During this period, funds in larger fund groups that are subject to the June 1, 2018 compliance date must satisfy their reporting obligation by maintaining in their records the information required to be included in Form N-PORT instead of submitting the information via EDGAR. For smaller fund groups, the compliance date will be delayed by nine months from the original compliance date (until March 1, 2020) and the requirement to submit reports on Form N-PORT on the EDGAR system is delayed from July 30, 2019 to April 30, 2020. As indicated in the final rule, larger entities have net assets of \$1 billion or more as of the end of the most recent fiscal year of the fund.

Adoption of New Form N-CEN and Rescission of Form N-SAR. New Form N-CEN, *Annual Report for Registered Investment Companies*, is a new form for funds to use to report census-type information to the SEC. Form N-SAR, the previous form on which the commission collected census-type information on management investment companies and UITs, is rescinded. Form N-CEN will be filed in a structured XML format and filed annually, rather than semi-annually as was required for reports on Form N-SAR by management companies. The compliance date was June 1, 2018.

Amendments to Regulation S-X. Requirements for standardized, enhanced disclosures about derivatives in investment company financial statements

are required by amendments to Regulation S-X. Under the amendments, the details about investments in derivatives are to be presented in a fund's schedule of investments, rather than in the notes to the financial statements. The compliance date for amendments related to Regulation S-X was August 1, 2017.

Disclosures Relating to Securities Lending Activities. Amendments to fund registration forms (that is, Forms N-1A and N-3) and reports on Form N-CSR (for closed-end funds only), require funds to disclose gross and net income from securities lending activities, fees and compensation in total and broken out by enumerated types, and a description of the services provided to the fund by the securities lending agent. The compliance date is consistent with amendments related to Regulation S-X.

Readers are encouraged to read the release at www.sec.gov. In addition, responses to frequently asked questions about investment company reporting modernization can be accessed via a link on the Division of Investment Management's page at www.sec.gov.

© Update 1-3 Regulatory: Investment Company Liquidity Disclosure

In September 2018, the SEC issued Release No. IC-33142, *Investment Company Liquidity Disclosure*. The final guidance is intended to improve the reporting and disclosure of liquidity information by registered open-end investment companies. In addition to a new requirement in Form N-1A for funds to disclose information about the operation and effectiveness of their liquidity risk management program in their reports to shareholders, the final guidance rescinds the requirement in Form N-PORT for funds to publicly disclose aggregate liquidity classification information about their portfolios. The amended Form N-PORT also allows funds to classify and report the liquidity of their investments in multiple liquidity classification categories for a single position, under specified circumstances, and requires that funds and other registrants report their holdings of cash and cash equivalents. The amendments were effective on September 10, 2018. The compliance dates are tiered based on asset size.

Amendments to Form N-PORT. The compliance date for large entities is June 1, 2019 (first N-PORT filing date of July 30, 2019). The compliance date for small entities is March 1, 2020 (first N-PORT filing date of April 30, 2020).

Amendments to Form N-1A. The compliance dates for large entities and small entities, respectively, is December 1, 2019, and June 1, 2020.

Readers should consult the full text of the release, which can be accessed on the Final Rules page at www.sec.gov.

1.47 The federal securities laws are supplemented by formal rules and regulations. The SEC issues a variety of releases and statements, including its financial reporting releases and releases under the 1933 Act, the 1934 Act, the 1940 Act, and the Investment Advisers Act of 1940. Many of these rules and regulations apply to the investment company industry. The auditor should be familiar with them and the SEC registration and reporting forms. The forms illustrate the kind of information that generally should be made available to the public, the restrictions imposed on operations, the most applicable

statutory provisions, and the statistics that generally should be accumulated and maintained. The forms commonly used include the following:¹¹

- a. Form N-8A, the notification of registration under the 1940 Act, discloses the company's name and address and certain other general information. An investment company is registered under the 1940 Act after it has filed the form, which is brief, and it is then subject to all the 1940 Act's requirements and standards. The information in the form need not be audited.
- b. Form N-1A, the registration statement of open-end companies under the 1940 Act (and, if elected, the 1933 Act), describes in detail the company's objectives, policies, management, investment restrictions, and similar matters. Form N-2 is the comparable registration statement for closed-end management investment companies. The initial filing of Forms N-1A and N-2 generally requires audited financial statements, which typically are limited to a "seed capital" statement of assets and liabilities. Part A of Form N-1A includes the information required in a fund's prospectus and states that the prospectus should clearly disclose the fundamental characteristics and investment risks of the fund using concise, straightforward, and easy to understand language. When an investment company incurs organization costs that are not paid for and assumed by the investment advisor, a "seed statement of operations" for the period from the organization date to the date of the statement of assets and liabilities for seed capital is also required (see chapter 8, "Other Accounts and Considerations," of this guide). The subsequent filing of posteffective amendments to the registration statement on Form N-1A is discussed in paragraph 1.49.¹²
- c. Form N-SAR was rescinded by SEC Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*.
- d. Form N-CSR, under which a registered investment company files its annual and semiannual shareholder reports together with the certifications of principal executive and financial officers required

¹¹ Although the commonly used forms are summarized in this listing, various other applicable investment company forms are not listed here because they are less commonly used. For a complete listing of applicable forms and additional resources, readers should visit the Forms List on www.sec.gov/forms.

¹² As noted in the May 2013 Expert Panel Conference Call Highlights, the SEC staff's position is generally, if a registered investment company or business development company acquires (or knowingly will acquire shortly after the registration statement is declared effective) a significant portion of a private fund, an entire private fund, or multiple private funds, the registrant should include in its registration statement at least 2 years of audited, Regulation S-X and U.S. generally accepted accounting principles compliant financial statements of the acquired private fund(s) (or private fund(s) to be acquired shortly after the registration statement is declared effective). For example, the registrant should include in the private fund(s)' financial statements a schedule of investments listing each investment in accordance with Article 12 of Regulation S-X as opposed to a condensed schedule of investments. In certain circumstances, the SEC staff may also request registrants to include in the registration statement unaudited interim financial statements of the private fund(s), an audited special purpose schedule of investments to be acquired, pro forma financial statements, seed financial statements, and/or supplemental information that has been provided to private fund investors. Also, there may be circumstances when additional narrative information regarding the adviser's decision to select a private fund(s) or a significant portion of a private fund(s) to be acquired should be disclosed (see May 2013 Expert Panel Conference Call Highlights for examples of narrative information). In considering what information may need to be included in the registration statement, consideration should be given such that investors of the existing private fund(s) do not have more information about the private fund(s) than potential investors of the new registrant.

by Rule 30a-2 of the 1940 Act. The form also provides for disclosure of other information relating to the investment company's code of ethics, audit committee financial expert, principal accountant fees and services, internal control over financial reporting, evaluation of disclosure controls and procedures, and (for closed-end funds) proxy-voting policies. Registered investment companies that include a summary portfolio schedule of investments in reports to shareholders file complete portfolio schedules for the semi-annual and annual shareholder reports on Form N-CSR. SBICs registered on Form N-5 and UITs are not required to file Form N-CSR.

- d. Form N-CSR, under which a registered investment company files its annual and semiannual shareholder reports together with the certifications of principal executive and financial officers required by Rule 30a-2 of the 1940 Act. The form also provides for disclosure of other information relating to the investment company's code of ethics, audit committee financial expert, principal accountant fees and services, internal control over financial reporting, evaluation of disclosure controls and procedures, and (for closed-end funds) proxy-voting policies. Registered investment companies that include a summary portfolio schedule of investments in reports to shareholders file complete portfolio schedules for the semi-annual and annual shareholder reports on Form N-CSR. SBICs registered on Form N-5 and UITs are not required to file Form N-CSR. Pending guidance from SEC Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*, amends Form N-CSR to require certain certifications by principal executive and financial officers of a fund and certain disclosures regarding securities lending activities. The compliance dates, which are tiered based on asset size, are identified in update 1-2 of this guide.
- e. Form N-Q, under which a registered investment company, other than an SBIC registered on Form N-5 and a BDC, files its complete portfolio schedules (the same schedules of investments that are required in Form N-CSR) for the first and third fiscal quarters under the 1934 Act and the 1940 Act. According to the acts, the form must be signed and certified by the principal executive and financial officers and also provides for disclosure of information relating to the investment company's evaluation of disclosure controls and procedures, and internal control over financial reporting. Per Sections 4 and 26 of the 1940 Act, UITs are not required to file Form N-Q.
- e. Form N-Q is being rescinded based on pending guidance from SEC Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*, to avoid unnecessarily duplication of information reported in new Form N-PORT. The compliance dates, which are tiered based on asset size, are identified in update 1-2 of this guide.
- f. Form N-MFP, a reporting form which is filed monthly by money market funds subject to Rule 2a-7 of the 1940 Act and reports pertinent information about the fund at both a series and class level, and about each portfolio security held on the last business day of

the preceding month. Form N-MFP requires funds to report information about the fund, including information about the fund's risk characteristics such as the dollar-weighted average maturity of the fund's portfolio and its seven-day gross yield. Money market funds also must report on Form N-MFP the market-based values of each portfolio security and the fund's market-based net asset value per share, with separate entries for values that do and do not take into account any capital support agreements into which the fund may have entered. Money market funds are required to disclose certain ratings for each portfolio security that the fund's board of directors considered in making its minimal credit risk determination and the name of the agency providing the rating. Significant changes to Form N-MFP resulted from the amendments in Final Rule Release No. 33-9616, *Money Market Fund Reform; Amendments to Form PF*. Among other provisions, the guidance requires a floating net asset value for prime institutional money market funds and provides nongovernment money market fund boards with new tools, liquidity fees, and redemption gates to address runs.

- g.* Form N-CR, a reporting form which is filed by money market funds subject to Rule 2a-7 of the 1940 Act upon the occurrence of one or more specified events which includes, but is not limited to events relating to, issuer default for one or more of the fund's portfolio securities; financial support received by the fund; or deviation from the stable net asset value.
- h.* Form N-PX, which reports the investment company's proxy voting record for each matter relating to a portfolio security considered at a shareholder meeting held during the 12-month period ending June 30.
- i.* Form 13F, a quarterly securities inventory of an institutional investment manager (including an investment company) that has either investment discretion or voting power over more than \$100 million in securities that are admitted to trading on a national securities exchange or the automated quotation system of a registered securities association. This form is usually filed in composite for an investment adviser of multiple clients, including the combined holdings of investment companies and other clients.
- j.* Schedule 13G and annual amendments, each as of December 31 to be filed by the following February 14, concern possession of either investment discretion or voting power over more than 5% of a class of equity securities of a publicly owned company, provided that the interests were acquired in the ordinary course of business and not with the purpose or effect of influencing control; if the provision is not applicable, disclosures of changes in holdings must be made promptly on Schedule 13D. Such reports are usually filed in composite form for an investment adviser of multiple clients, including the combined holdings of investment companies and other clients.
- k.* Form N-3, the registration statement for variable annuity separate accounts registered as management investment companies under the 1940 Act and the 1933 Act. The form contains information and financial statements similar to the kind found in Form N-1A and information about the insurance contract and sponsoring insurance company, including financial statements of the sponsor.

- l.* Form N-4, the registration statement for variable annuity separate accounts registered as UITs under the 1940 Act and the 1933 Act. Information supplied in Form N-4 is similar to the information presented in Form N-1A.
- m.* Form N-1 is the registration statement for variable life insurance separate accounts registered as management investment companies under the 1940 Act and the 1933 Act.
- n.* Form N-6, the form for insurance company separate accounts that are registered as UITs and that offer variable life insurance policies.
- o.* Forms N-8, B-2, and S-6, the forms for all UITs except those variable annuity and variable life separate accounts registered on Forms N-4 and N-6, respectively, under the 1940 Act and the 1933 Act.
- p.* Form N-5, the registration statement for SBICs, which are also licensed under the Small Business Investment Act of 1958. This form is a dual-purpose form for registering SBICs under both the 1933 Act and the 1940 Act. The form contains the same kind of information and audited financial statements as required by Forms N-1A and N-2 for management investment companies.
- q.* Form N-14, the statement for registration of securities issued by investment companies and BDCs in business combination transactions under the 1933 Act. The form contains information about the companies involved in the transaction, historical financial statements, and, as applicable, pro forma financial statements.¹³
- r.* Form PF, the form required to be filed by SEC-registered investment advisers that manage one or more private funds¹⁴ with aggregate private fund regulatory assets under management of greater than or equal to \$150 million as of the recently completed fiscal year. The information on this form includes information about the private funds' gross and net asset values, counterparty exposures, risk, collateral or borrowing, investor makeup, derivative exposures, investment composition by type and by geographic exposure, portfolio liquidity, portfolio turnover, strategy, performance, and clearing mechanism. SEC-registered investment advisers that are also registered as commodity pool operators with the Commodity Futures Trading Commission (CFTC) may satisfy the CFTC's requirement to file systematic information about their commodity pools by filing Form PF with the SEC instead of filing the same information on Form CPO-PQR¹⁵ with the CFTC. Significant changes to Form PF resulted from the amendments in Final Rule Release No. 33-9616. The amendments apply only to large liquidity fund advisers (generally SEC-registered investment advisers that advise

¹³ See footnote 13 in chapter 8, "Other Accounts and Considerations," of this guide.

¹⁴ As defined in the Form PF Glossary of Terms, for purposes of Form PF, a private fund is any issuer that would be an investment company as defined in Section 3 of the 1940 Act, except for Sections 3(c)(1) or 3(c)(7) of the 1940 Act.

¹⁵ Form CPO-PQR is required to be filed quarterly with the Commodity Futures Trading Commission (CFTC) or National Futures Association (NFA), depending on the size of the commodity pool operator and its pools. The information included on this form, depends on the size of the commodity pools, and may include information about each commodity pool operator, its service providers, investment strategies, risk exposures, leverage and derivative positions.

at least one liquidity fund and manage, collectively with their related persons, at least \$1 billion in combined liquidity fund and money market fund assets). Under the amendments, for each liquidity fund managed, large liquidity fund advisers are required to provide, quarterly and with respect to each portfolio security, additional information for each month of the reporting period.

- s. Form N-CEN, *Annual Report for Registered Investment Companies*, is a form for funds to use to report census-type information to the SEC. The form is required for all registered investment companies, except face-amount certificate companies; BDC are not registered investment companies and are not required to file reports on Form N-CEN. Certain sections of the form are required to be completed for all registrants; applicability of other sections depends on the type of registrant. The sections pertain to the following: all management companies, other than SBICs; closed-end funds and SBICs; ETFs (including those that are UITs); and UITs. The report filed by management investment companies, other than SBICs, must be accompanied by a report on the company's internal control over financial reporting from their independent registered public accounting firm (see paragraph 12.35 of this guide for an example of that report). Form N-CEN replaces Form N-SAR, which is being rescinded by SEC Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*.
- t. Form N-PORT is a new form required under pending guidance from SEC Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*. Form N-PORT will be used by certain registered investment companies other than money market funds to report information about their monthly portfolio holdings in a structured data format. The compliance dates, which are tiered based on the size of the fund group, are identified in updates 1-2 and 1-3 of this guide.

1.48 Prospectuses of mutual funds offering their shares for sale are updated at least annually. Information in a currently effective prospectus generally should be updated for significant events that have occurred since the effective date. Posteffective amendments on Form N-1A, including updated audited financial statements and a complete schedule of investments (if not included within the financial statements), must be filed and become effective under the 1933 Act and the 1940 Act within 16 months after the end of the period covered by the previous audited financial statements if the fund is to continue offering its shares.

1.49 Registration statements and reports filed by open-end and closed-end companies (other than SBICs) on various forms include financial highlights, usually for the preceding 5 years, as described in the instructions to Form N-1A, and for the preceding 10 years as described in the instructions to Form N-2 (with at least the most recent 5 years audited).

1.50 The form and content of financial statements required in registration statements are governed by Regulation S-X. Article 6, and portions of Article 12, of Regulation S-X specifically address registered investment companies. (SBICs are covered in Article 5, but they follow the same fair value accounting model as do other investment companies.) Registration statements and Forms N-SAR

and N-CSR are filed using the SEC's Electronic Data Gathering Analysis and Retrieval System.

The form and content of financial statements required in registration statements are governed by Regulation S-X, Article 6, and portions of Article 12, of Regulation S-X specifically address registered investment companies. (SBICs are covered in Article 5, but they follow the same fair value accounting model as do other investment companies.) Registration statements and Forms N-CEN¹⁶ and N-CSR are filed using the SEC's Electronic Data Gathering Analysis and Retrieval System.

1.51 In June 2018, SEC issued Final Rule Release Nos. 33-10514; 34-83551; IC-33139, *Inline XBRL Filing of Tagged Data*. The final rule requires the use of the Inline eXtensible Business Reporting Language (XBRL) format for the submission of operating company financial statement information and fund risk/return summary information. The final rule also eliminates the 15 business day XBRL filing period for fund risk/return summaries and the requirement for operating companies and funds to post "Interactive Data Files" on their websites. In addition, the file rule terminates the voluntary program for submission of financial statement information interactive data that was available only to investment companies and certain other entities. The amendments were effective on September 17, 2018. Compliance dates for large fund groups and small fund groups, respectively, are two years and three years after the effective date (that is, September 17, 2020 and September 17, 2021). Readers should consult the full text of the release, which can be accessed on the Final Rules page at www.sec.gov.

Financial Reporting to Shareholders

1.52 The 1940 Act and the related rules and regulations specify the financial statements of registered investment companies and the timing of reports required to be submitted to shareholders and the SEC.¹⁷ According to the 1940 Act and the related rules, reports containing those financial statements must be submitted to shareholders and the SEC at least semiannually; annual reports must contain audited financial statements. Financial statements in such reports include

- a statement of assets and liabilities and a detailed schedule of investments or a statement of net assets. The SEC, under Regulation S-X, permits a registered investment company to include in its reports to shareholders a summary portfolio schedule of investments, provided that the complete portfolio schedule is filed with the SEC on Form N-CSR semiannually and provided to shareholders free of charge. Regulation S-X also exempts money market funds from including a portfolio schedule in reports to shareholders provided that information is filed with the SEC on Form

¹⁶ Form N-CEN, *Annual Report for Registered Investment Companies*, is a new form required under SEC Release Nos. 33-10231; 34-79095; IC-32314; *Investment Company Reporting Modernization*. Funds will use the new form to report census-type information to the SEC. Form N-SAR, the previous form on which the SEC collected census-type information on management investment companies and unit investment trusts, was rescinded. The compliance date was June 1, 2018.

¹⁷ Rules under Section 30(d) of the 1940 Act.

N-CSR semiannually and provided to shareholders upon request free of charge. (Despite this exemption, U.S. generally accepted accounting principles does require a condensed portfolio. See paragraphs 7.27–30 of this guide for further guidance.)

- a statement of operations.
- a statement of changes in net assets.

In addition to the basic financial statements, financial highlights (see paragraph 7.173 of this guide) should be presented either as a separate schedule or within the notes to the financial statements. Financial statements for registered and nonregistered investment companies are discussed and illustrated in chapter 7, "Financial Statements of Investment Companies," of this guide. For investment companies with complex capital structures, including those that issue multiple classes of shares, the reporting requirements and related illustrative financial statements are discussed in chapter 5 of this guide.

1.53 Registered and nonregistered investment companies also may be required to present a statement of cash flows if they do not meet the conditions specified in FASB ASC 230-10-15-4. The scope exceptions provided in FASB ASC 230-10-15-4 are discussed in paragraph 7.160 of this guide.

Accounting Rules and Policies

1.54 Rules under Section 31 of the 1940 Act prescribe the accounting records that an investment company must maintain and the periods for which they must be retained. Those rules require maintenance of journals, general and subsidiary ledgers, and memorandum records that are subject to examination by representatives of the SEC during periodic and special examinations.

1.55 The accounting policies followed by investment companies result from the companies' role as conduits for the funds of investors interested in investing as a group. Furthermore, the investment company policies are supplemented by the rules and regulations issued under the various acts administered by the SEC and the SBA. Some unique policies are described in more detail in the following chapters.

Effective Date of Transactions

1.56 FASB ASC 946-320-25 explains that when accounting for security purchases and sales, for financial reporting purposes, an investment company is to record transactions as of the trade date (the date on which the company agrees to purchase or sell the securities), so that the effects of all securities trades entered into by or for the account of the investment company to the date of a financial report are included in the financial report. Investment companies record dividend income on the ex-dividend date, not the declaration, record, or payable date, because on the ex-dividend date, the quoted market price of listed securities and other market-traded securities tends to be affected by the exclusion of the dividend declared. Also, investment companies record liabilities for dividends payable to shareholders on the ex-dividend or ex-distribution date, not the declaration date as other corporations do, because mutual fund shares are purchased and redeemed at prices equal to or based on net asset value. Investors purchasing shares between the declaration and ex-dividend dates are entitled to receive the dividend, whereas investors purchasing shares on or after the ex-dividend date are not entitled to the dividend.

1.57 However, Rule 2a-4 of the 1940 Act permits registered investment companies to record security transactions as of one day after the trade date for purposes of determining net asset value.

Other Rules and Regulations

Money Market Reform

1.58 On July 23, 2014, the SEC issued Final Rule Release No. 33-9616. Under the Money Market Reform Rule, institutional prime and municipal money market funds are required to transact at a floating net asset value and are expected to determine the values of their investments using market-based values, as opposed to using the amortized cost of such investments as an approximation of market value. Retail funds and government funds are not required to transact at a floating net asset value. Institutional prime and municipal money market funds must transact shares, rounded to the fourth decimal place (for example, \$1.0000), based on the most recently determined market value of the securities in the underlying portfolios. Separately, new tax regulations and guidance have been issued as a result of this change; readers are encouraged to review this new IRS guidance.

Additionally, the amendments in Final Rule Release No. 33-9616 gave the boards of directors of money market funds tools to stem heavy redemptions, including discretion to impose liquidity fees in the event a fund's weekly liquidity level falls below the required regulatory threshold and the discretion to suspend redemptions temporarily (that is, impose a "gate"), under similar circumstances. All nongovernment money market funds also must impose a liquidity fee if the fund's weekly liquidity level falls below the rule-established threshold, unless the fund's board determines that imposing such a fee is not in the best interests of the fund.

Final Rule Release No. 33-9616 also contains enhanced disclosure requirements on fund websites, sales and marketing materials, prospectuses and SAIs; changes to Form N-MFF; an additional new Form N-CR; and various clarifying amendments under Rule 2a-7, including stress testing and diversification provisions.

The amendments also require investment advisers of certain large unregistered liquidity funds to provide additional information about those funds to the SEC.

Readers should consult the full text of SEC Final Rule Release No. 33-9616, which can be accessed on the Final Rules page at www.sec.gov.

Other Requirements

1.59 The 1934 Act specifies the records that must be maintained by the principal underwriter for the fund, the period for which the records must be preserved, and the reports that the principal underwriter must file with the SEC. The records are subject to examination by representatives of the SEC.¹⁸ Once during each calendar year, each principal underwriter is required by Section 17 of the 1934 Act, and related rules, (as are other broker-dealers) to file audited financial statements, related footnotes, either a compliance report or

¹⁸ Rules 17a-4 and 17a-5 of the Securities Exchange Act of 1934.

an exemption report, and supplemental information related to certain financial responsibility rules. These significant amendments are discussed in further detail within AICPA Accounting Guide *Brokers and Dealers in Securities*.

1.60 Section 19 and Rule 19a of the 1940 Act specify the kind of notice to shareholders that should accompany distributions from sources other than accumulated undistributed income determined in accordance with good accounting practice (or net income for the current or preceding fiscal year), describing the source of such distributions. That notice must indicate clearly the portion of the payment (per share of outstanding capital stock) made from net investment income or accumulated undistributed net investment income, realized gains, accumulated undistributed net realized gains on the sales of securities, and capital. Rule 19a-1(e) further requires that "the source or sources from which a dividend is paid shall be determined (or reasonably estimated) to the close of the period as of which it is paid without giving effect to such payment."

1.61 Section 32(a) of the 1940 Act requires that the independent auditor reporting on financial statements of an investment company be selected annually by a majority of directors or trustees who are not interested persons at a meeting held no more than 30 days before or after the commencement of the investment company's fiscal year or before the annual meeting of stockholders in that year. Additionally, if the investment company is organized in a jurisdiction that does not require annual shareholder meetings and the investment company does not hold a meeting in a given year and is part of a complex of related investment companies that do not share a common fiscal year, the independent auditor may be selected by the directors or trustees at a meeting held either within 30 days before or within the first 30 days after the commencement of that company's fiscal year. The directors' or trustees' selection must be submitted to the stockholders for ratification during any year in which an annual meeting of stockholders is held, unless the appointment of the auditors is approved by an audit committee solely comprising independent directors or trustees, and the audit committee maintains a charter in an easily accessible place. The employment of the accountant is conditioned upon the right of the investment company to terminate such employment without any penalty by a vote of the outstanding shares of the investment company. If the independent auditor resigns or is unable to carry out the engagement, the disinterested directors or trustees may appoint a successor.¹⁹

Jumpstart Our Business Startups Act (JOBS Act)

1.62 The Jumpstart Our Business Startups Act (JOBS Act) was enacted on April 5, 2012, with the purpose of stimulating the growth of small to mid-sized companies by making it easier for startup and emerging growth companies to raise capital and to meet regulatory reporting requirements. The SEC's Division of Corporation Finance released frequently asked questions (FAQs) to provide guidance on the implementation and application of the JOBS Act. Questions 20–21 specifically address investment companies.

1.63 The JOBS Act creates regulatory relief for a new type of issuer — the emerging growth company. An *emerging growth company* is defined as any issuer with gross revenues of less than \$1 billion ("the threshold amount") during the prior fiscal year that has gone public after December 8, 2011. The threshold amount is indexed for inflation by SEC. The inflation-adjusted amount, as

¹⁹ Section 32(a), Rule 32a-3, and Rule 32a-4 of the 1940 Act.

described in Release Nos. 33-10332; 34-80355, *Inflation Adjustments and Other Technical Amendments under Titles I and III of The Jobs Act*, is \$1.07 billion ("the inflation-adjusted amount"). An issuer can maintain its emerging growth company status for five years following its initial public offering unless it has total annual gross revenues that exceed the inflation-adjusted amount, becomes a large accelerated filer, or issues nonconvertible debt in the threshold amount, or more, in a three-year period. According to questions 20–21 of the FAQs, an investment company registered under the 1940 Act would not qualify as an emerging growth company under Title I of the JOBS Act. Registered investment companies are subject to separate disclosure and reporting requirements, which were designed to address the particular structure and operations of investment companies.

1.64 However, BDCs may qualify as emerging growth companies. BDCs invest in startup and emerging growth companies for which they may provide significant managerial experience and are subject to many of the disclosure and other requirements from which Title I provides temporary exemptions, including executive compensation disclosure, say-on-pay votes, Management Discussion and Analysis, and Section 404(b) of the Sarbanes-Oxley Act.

Regulatory Changes for Investment Companies That Invest in Commodities

1.65 Any collective investment vehicle that is operated for the purpose of trading commodity futures and options on commodity futures contracts is deemed under applicable CFTC regulations to constitute a commodity pool, subject to limited exclusions for "otherwise regulated" entities that make limited use of futures. Historically, registered investment companies that engaged in commodity futures trading activities were excluded from CFTC regulations under the CPO definition exemption criteria in Section 4.5 of the Commodity Exchange Act (CEA). However on February 9, 2012, the CFTC issued a final rule changing Part 4 of the CEA's regulations involving registration and compliance obligations for CPOs and CTAs (see CFTC Release No. PR6176-12). The rule reinstated the trading criteria for advisers of registered investment companies claiming exclusion from the CPO definition under Section 4.5 of the CEA and added an alternative trading threshold based on net notional value of derivative positions. The rule also rescinded the exemption from CPO registration under Section 4.13(a)(4) and included new risk disclosure requirements for CPOs and CTAs regarding non securities-based swap transactions. As a result of this final rule, many registered investment companies that invest in commodities are no longer exempt from CFTC regulations and therefore are within the scope of both the SEC and CFTC.

1.66 To reduce the regulatory compliance burdens on registered investment companies affected by the changes to Section 4.5 of the CEA (see paragraph 1.35), the CFTC issued an additional final rule²⁰ in August 2013 that harmonizes SEC and CFTC rules for the advisers of registered investment companies that are required to register as CPOs. The rule explains that for entities that are registered with both the CFTC and SEC (dual registrants), the CFTC

²⁰ CFTC Release No. PR6663-13 issued on August 13, 2013. Readers are encouraged to review the full text of the final rule available at www.cftc.gov. The related Fact Sheet and Questions and Answers were issued by the CFTC in conjunction with the final rule release and can also be accessed at www.cftc.gov.

will accept the SEC's disclosure, reporting, and recordkeeping regime as substituted compliance for substantially all of Part 4 of the CFTC's regulations, as long as they comply with comparable requirements under the SEC's statutory and regulatory compliance regime. Essentially, the final rule allows dually registered entities to meet certain CFTC regulatory requirements for CPOs by complying with SEC rules to which they are already subject.²¹

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²¹ In January 2017, CFTC issued CFTC Letter No. 17-04, *Exemptive Relief from the Requirement in Commission Regulation 4.22(c)(7) to Obtain Participant Waivers to Provide Unaudited Financial Statements when Liquidating a Series of a Registered Investment Company*. In the letter, CFTC states that "the Division grants the CPO of a liquidating series of a RIC relief from the participant waiver provision of Commission Regulation 4.22(c)(7)(iii), such that the CPO may nonetheless prepare, and provide to participants and NFA, unaudited Statements of Operations and changes in Net Assets in accordance with Commission Regulation 4.22(c)(7)." [CFTC Letter No. 17-04, "Exemption," January 26, 2017, from the CFTC website, www.cftc.gov/lawregulation/cftcstaffletters/exemptiveletters/index.htm, accessed April 4, 2017.] Readers are encouraged to view the letter in its entirety.