

Derivatives - USA

Proposed SEC data collection rules focus on use of derivatives by asset managers

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Introduction

In the wake of the financial crisis, the Securities and Exchange Commission (SEC) adopted detailed data reporting rules for private funds on both Form ADV (2010) and Form PF (2011). In its continuing push to gather more asset management industry data, officials have been hinting for months that portfolio-level reports on investment adviser separate accounts and registered investment companies would be next. The SEC now intends to close these perceived gaps through a pair of rule proposals which, when taken together, suggest some of the strongest regulatory interest to date in how derivatives are used in the asset management industry.⁽¹⁾

New separate account data reporting

At present, the SEC collects limited data from investment advisers regarding their separately managed client accounts. However, proposed amendments to Form ADV (which is the SEC's registration form used by investment adviser firms) would capture a battery of new information. As proposed, registered investment advisers would do as follows:

- Report the approximate percentage of separately managed account assets invested in 10 broad asset categories, such as exchange-traded equity securities and US government/agency bonds.
- Identify any custodians that account for at least 10% of the adviser's separately managed account assets and the amount of the adviser's assets under management attributable to separately managed accounts held at each custodian.
- Report on the use of borrowings and derivatives in any separately managed account with a net asset value of at least \$10 million, as follows:
 - All advisers would report the percentage of these separately managed account assets held in derivatives.
 - Advisers with at least \$150 million but less than \$10 billion in "regulatory assets under management" (RAUM, a term used by the SEC to refer to gross assets) attributable to separately managed accounts would report the number of accounts that correspond to certain categories of gross notional exposure and the weighted average amount of borrowings (as a percentage of net asset value) in those accounts.
 - Advisers with at least \$10 billion in RAUM attributable to separately managed accounts would report the gross notional exposure and borrowing information described above, as well as the weighted average gross notional value of derivatives (as a percentage of the net asset value) in each of six different categories of derivative.

All advisers would report this separate account information on Form ADV annually. Advisers with at least \$10 billion in RAUM would report both mid-year and year-end information (so information as of twice a year), but only as part of a single annual report. Form ADV filings are public on the SEC website, so the prospect of public availability of this kind of granular account data is expected to be controversial.

Investment company reporting

Form N-PORT

At present, SEC-registered management investment companies, other than small business investment companies, must report their complete portfolio holdings to the SEC (and the public) on a quarterly basis. These funds file reports on Form N-Q as of the end of each first and third fiscal quarter and on Form N-CSR as of the end of each second and fourth fiscal quarter. As proposed, the SEC would rescind Form N-Q and in its place adopt a new portfolio holdings reporting form, Form N-

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PORT, which would be filed by all registered management investment companies (including unit investment trusts that operate as exchange-traded funds), other than money market funds and small business investment companies.

Form N-PORT would include new information that is not currently required to be calculated or compiled. For example, the form would require certain risk metric calculations intended to measure a fund's exposure and sensitivity to changing market conditions (ie, changes in asset prices, interest rates or credit spreads). New information about fund activities such as securities lending, repurchase agreements and reverse repurchase agreements, over-the-counter derivatives transactions and the counterparties to which the fund is exposed in those transactions would also be required.

Specifically, a section of the form to be titled "Portfolio Level Risk Metrics" would require funds that invests in debt instruments or derivatives that provide exposure to debt instruments or interest rates representing at least 20% of the fund's notional exposure to provide a portfolio-level calculation of duration and spread duration across the applicable maturities in the fund's portfolio. Additionally, a section to be titled "Return Information" would require funds to report monthly net realised gain (or loss) and net change in unrealised appreciation (or depreciation) for each of the preceding three months, attributable to derivatives for each of the following categories: commodity contracts, credit contracts, equity contracts, foreign exchange contracts, interest rate contracts and other derivatives contracts.

The proposal would require funds to report information on Form N-PORT monthly in an XML format no later than 30 days after the end of each month. Once filed, the report for every third month would become available to the public 60 days after the end of the fund's fiscal quarter. This cycle has the effect that Form N-PORT would be filed for two months out of every three on a non-public basis. The third month would be public, but only after a lag that approximates which for existing public financial reports by registered investment companies.

Amendments to Regulation S-X

The proposal also includes amendments to Regulation S-X, which prescribes the form and content of financial statements required in fund registration statements and shareholder reports. At present, Regulation S-X does not prescribe specific information for most types of derivative, including swaps, futures and forwards, with the result that disclosure practices can vary significantly firm to firm. The proposed amendments would both enhance and standardise derivatives disclosures in fund financial statements. Many of the proposed amendments to Regulation S-X, particularly the amendments to the disclosures concerning derivative contracts, are similar to proposed requirements under Form N-PORT.

Among other things, proposed amendments to Articles 6 and 12 of Regulation S-X would require new, standardised disclosures regarding fund holdings in open futures contracts, open forward foreign currency contracts and open and additional disclosures regarding fund holdings of written and purchased option contracts. The amendments would also require more prominent placement of disclosures regarding investments in derivatives in a fund's financial statements than is customary today.

Comment

Both proposals introduce significant changes in the public reporting of the use of derivatives by asset managers. They therefore can be expected to be the subject of lively commentary going forward.

However, the largest players in the industry may be more supportive of the proposals than expected. Other financial regulators have shown a growing interest in the asset management industry and close observers will recognise that these new data collection and reporting initiatives relate – at least in part – to jockeying for position as between the SEC and those other players. In other words, without this push by the SEC, other regulators could see more room to step in, with potentially unpredictable goals and outcomes.

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Endnotes

(1) The SEC proposed rule on investment company reporting modernisation is available at www.sec.gov/rules/proposed/2015/33-9776.pdf and the SEC proposed rule on amendments to Form ADV and Investment Advisers Act Rules is available at www.sec.gov/rules/proposed/2015/ia-4091.pdf.

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