

Mutual Fund Directors and Investment Advisers Digest

SEC proposal and the impact on the reporting of information by investment companies and investment advisers: The costs and benefits

Background

On May 20, 2015, the US Securities and Exchange Commission (SEC or "Commission") issued proposed rules, forms, and amendments that the SEC believes will increase and improve the reporting and disclosure of information provided by investment companies¹ and investment advisers². The rules are being proposed in order to provide additional information to investors and to more effectively gather data of investment companies and investment advisers. Comments are due 60 days after publication in the Federal Register. The very next day, David Grim, the new Director of the SEC Division of Investment Management, was quoted as saying "data is power"³, signaling to the industry that the SEC is serious about monitoring the investment management industry through the use of robust data analysis.

Also, the proposals are not just additive rules to the industry, but suggest to eliminate Form N-SAR and create cost savings by allowing for the posting of mutual fund financial statements to a website, thereby changing the default option criteria. The latter represents a change the industry has long awaited and has immediate cost savings to the investment management industry. However, the balance of costs and benefits and which way the scale tips, will not be decided until the final rule is issued and implementation is complete.

Investment company reporting modernization

In order to modernize the reporting and disclosure of information by investment companies and to assist the SEC in gathering more meaningful information for their analytical tools, the SEC has proposed the following:

- A new Form N-PORT, which will replace Form N-Q and require monthly disclosure of portfolio holdings for certain investment companies along with additional information not currently required in Form N-Q or Form N-CSR.
- Amendments to Regulation S-X, among other proposed changes, requiring standardized disclosures for derivatives and securities lending.
- Allowing funds to require certain information online and change the default option criteria.
- Replace Form N-SAR with Form N-CEN. This new form will have similar information to Form N-SAR, but will be updated to provide information that is more relevant. Additionally, Form N-CEN will be filed annually instead of the semi-annual requirement for Form N-SAR.
- Both Form N-PORT and N-CEN will be required to be filed using the standard XML format.



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Amendments to Form ADV and Investment Advisers Act

The amendments to Form ADV and the Investment Advisers Act are being proposed to provide more information regarding investment advisers.

Form ADV

The proposed amendments to Form ADV will require additional information regarding separately managed accounts (SMAs), umbrella registration, and other clarifying, technical, and other amendments to the form.

With regard to SMAs, more information on the holdings will be required, such as the reporting of regulatory assets under management into ten broad categories. For those advisers with at least \$150 million in assets in separately managed accounts, information on the use of derivatives and borrowings will be required, including gross notional exposure and weighted average borrowings. Further details will be required for those advisers with more than \$10 billion in assets in SMAs. Finally, the SEC would require the adviser to identify those custodians that account for 10 percent or more of the SMAs regulatory assets under management and the adviser's regulatory assets under management that are attributed to SMAs held at the custodian.

¹ <http://www.sec.gov/rules/proposed/2015/33-9776.pdf>

² <http://www.sec.gov/rules/proposed/2015/ia-4091.pdf>

³ Peter Ortiz, New SEC Investment Management Chief: "Data is Power", Ignites, May 26, 2015

For those entities that operate multiple private investment adviser entities under a single advisory business, proposed amendments to Form ADV are being made to make it more effective to file such information.

Investment Adviser Act rule amendments

The SEC is proposing two amendments to the books and records rule of the Investment Adviser Act. One amendment will require that advisers maintain the information they used to calculate and determine performance information that they distribute to investors. The current rule only requires them to maintain the information if it is sent to 10 or more persons. The SEC also continues to focus on understanding the underlying attributes that impact performance and disclosure around such underlying attributes that are short-term, non-recurring in nature. The other amendment will require advisers to maintain original documents of any written communications received and copies of written communications sent that relate to performance of their managed accounts or security recommendations.

Compliance dates

Form N-PORT and N-CEN have proposed compliance dates of 18 months after they become effective. The changes to Regulation S-X would be eight months after the effective date. There were no specified compliance dates for the amendments to Form ADV or the Investment Advisers Act Rule amendments. This compliance timeline has been a discussion of immediate concern of the investment management industry and whether compliance can be achieved. Also, in the discussion are whether such reporting requirements should be outsourced. We anticipate the topic of compliance dates will be included in many of the comment letters the SEC most likely will receive on this rule proposal.

Key impacts of these proposals

While the SEC believes these new proposals will ultimately lead to more meaningful reporting and increase the effectiveness of its ability to conduct industry-wide analysis, the potential cost burden remains difficult to quantify. The additional information required in the new forms will force investment advisers to develop systems that allow them to extract the required data in an effective and timely fashion and many may consider whether to outsource this activity to other service providers. The monthly

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reporting required by form N-PORT and the additional information required for the impact of interest, credit, and asset risks on derivatives will require a significant investment in technology and personnel to ensure that such information is prepared timely and accurately prepared.

In recognition of the changing way in which investors consume information about mutual funds and other investment opportunities, the investment company reporting modernization project proposes to allow investment companies to satisfy the requirement to transmit shareholder reports by posting the information on the fund's website, subject to certain conditions. This has certainly been the desire of the industry for some time, and should be a welcome change that could lead to significant cost savings for investors, the fund industry, as well as reducing the cost of the mutual fund reporting regime. For advisers, the changes to Form ADV are designed to make the form more efficient and effective, but it will require additional reporting and tracking of information of SMAs by investment advisers. Similar to the proposals for investment companies, developing systems and procedures to capture the new data around derivatives and borrowing activity could present challenges for these investment advisers as well.

The SEC believes the new reporting will assist them in monitoring investment advisers and allow it to more easily identify outliers for outreach and inspection. Certainly, those adviser entities that operate multiple private investment adviser entities under a single advisory business could find the new proposal creates a more efficient means of filing their required information. A potential benefit could be proactive SEC oversight and monitoring that that could end the discussion to designate large asset managers as SIFI's, thereby eliminating additional regulatory burden.

Finally, the proposed changes to the Investment Advisers Act could require investment advisers to create more robust policies and procedures to capture and maintain additional documentation around performance calculations and information provided to investors.

Bottom line

Ultimately, the new proposals outlined above will have a significant impact on the current reporting requirements of investment companies and investment advisers. These enhancements to the reporting requirements will likely come at a cost to investment advisers and will require management to determine how they will gather the information requested in order to comply with the new requirements. Beginning the dialogue now will be important to allow for an effective implementation of the new reporting regime if and when the rules become effective. In addition, translating this dialogue into constructive feedback to the SEC staff will go a long way to tipping the scale and enhancing a positive outcome for the investment management industry. We believe that the number of comment letters written in response to this proposal will be high given the potential impact to the industry. Comments received from mutual fund directors always receive high consideration. Thus, mutual fund directors and investment advisers should carefully evaluate the impact on the mutual fund's operations and cost structure and consider commenting on this groundbreaking proposal.

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