SEC PROPOSES NEW REPORTING REQUIREMENTS FOR REGISTERED FUNDS

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Investment Management Alert

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EXECUTIVE SUMMARY AND ANALYSIS OF THE PROPOSED AMENDMENTS

Introduction

On May 20, 2015, the Securities and Exchange Commission ("SEC") proposed rules, forms and amendments under the Investment Company Act of 1940 (the "1940 Act") and related regulations (together, the "Proposed Amendments") that would impose new and expanded disclosure and reporting obligations on registered investment companies ("funds").[1] The Proposed Amendments are part of an effort to capture key information about funds' investment practices on a more frequent basis and in a format that better enables the SEC staff to aggregate and analyze the data.

The Proposed Amendments would both broaden and deepen the nature of information the SEC receives about funds and their practices by (i) mandating reporting of information not previously reported to the SEC (such as risk metrics and detailed derivatives information); and (ii) converting certain of the information currently reported to the SEC into a modernized, structured data format. The SEC proposes two new reporting forms. Form N-PORT would replace current Form N-Q and would require monthly reporting of fund portfolio holdings and detailed information about funds' derivative usage, risk metrics related to debt securities, counterparty exposure and securities lending transactions, among other things. Form N-CEN would replace current Form N-SAR and require annual reporting of census data.

Form N-PORT and Form N-CEN are primarily designed as tools for the SEC and its staff in their oversight of the fund industry; the forms are not intended to be investor disclosure documents, although Form N-PORT will be publicly available on a limited basis. The new reporting requirements are intended to assist the SEC staff with assessing funds' regulatory compliance, identifying funds for examination, pursuing enforcement actions against funds, and monitoring risks of individual funds, as well as industry-wide trends and risks. The SEC anticipates that the data gathered will also inform policy making.

Further, the SEC notes that both sophisticated institutional investors and third-party users that provide services to investors may find Form N-PORT disclosures useful for analyzing funds' investment practices. For example, institutional investors could directly use the data from the information on proposed Form N-PORT for their own quantitative analysis of funds, including to better understand the funds' investment strategies and risks, and to better compare funds with similar strategies.

Fund firms are likely to incur increased costs as a result of the Proposed Amendments, which may be significant given the detailed nature of the information being requested and the frequency with which funds will be required

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to file. Further, the SEC's access to such additional and enhanced information may have important consequences for funds with respect to SEC examinations and enforcement actions. At a minimum, the SEC staff may use the new and enhanced information that funds would report under the Proposed Amendments in its selection of which funds to examine. For example, proposed Form N-PORT would require funds to report monthly total returns for each of the previous three months. The SEC notes that this information could reveal performance outliers, or performance that appears to be inconsistent with a fund's investment strategy or other benchmarks, which may prompt further inquiries from the SEC staff. The SEC staff may base its selection of funds for examination on more specific criteria, and will have more information about a fund's investment practices at the outset of an exam. While it remains to be seen whether this access to new and enhanced information would lead to an increase in SEC enforcement actions, or perhaps a change in the nature and types of such actions, this will be an important consideration for funds if the Proposed Amendments become effective.

Fast Facts on the Proposed Rule Changes

The Proposed Amendments are published on the SEC's website and in the Federal Register. The public comment period for the proposals ends on August 11, 2015 (*i.e.*, 60 days after publication in the Federal Register). For a summary of the comments requested in the Proposed Amendments, please see Appendices 1 and 2.

Form N-PORT

- Funds (other than money market funds ("MMFs") and small business investment companies ("SBICs")) would be required to report portfolio-wide and position-level holdings data and certain risk metrics monthly, in a structured data ("XML") format.
- Form N-PORT would replace current Form N-Q, which funds currently file as of the end of each first and third fiscal quarter.
- Form N-PORT would require reporting of the portfolio holdings information currently contained in Form N-Q reports, but would also impose significant new reporting requirements, including: (1) quantitative risk metrics data for funds with at least 20% notional debt exposure; (2) detailed information about the characteristics and terms of each derivatives contract; (3) information about liquidity, pricing and fund flows; and (4) information about securities lending transactions and counterparty exposures.
- Form N-PORT would be filed monthly, but only the information reported for the third month of a fund's fiscal quarter would be made publicly available, and only after a 60-day delay.
- Smaller funds and fund groups (as described below in Appendix 1) would have 30 months after the effective date to comply, while larger funds and fund groups would have 18 months after the effective date to comply.
- For a more in-depth summary of Form N-PORT and its requirements, as well as the comments requested by the SEC with respect to Form N-PORT, please see Appendix 1.

Form N-CEN

- Form N-CEN would require funds (other than face amount certificate companies) to report a wide variety of census information annually, in XML format.

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- Form N-CEN would replace current Form N-SAR, which funds file semiannually. Form N-CEN would require much of the information reported on Form N-SAR while replacing items that are outdated or no longer informative with new reporting items.
- New reporting items include information about investments in controlled foreign corporations, securities lending transactions and the identity of a fund's pricing vendors.
- Funds would have 18 months after the effective date to comply.
- For a more in-depth summary of Form N-CEN, as well as the comments requested by the SEC with respect to Form N-CEN, please see Appendix 2.

Other Proposed Rule Changes Related to Funds' Reporting

- *Amendments to Regulation S-X*: Amendments to Regulation S-X would standardize and enhance derivatives holdings disclosures in fund financial statements, as well as other disclosures related to liquidity and pricing of investments. Such disclosures would be placed prominently in, rather than in the notes to, the financial statements. Funds would have 8 months after the effective date to comply.
- *Rule 30e-3 (E-delivery of Shareholder Reports)*: Rule 30e-3 would permit (but not require) funds to provide shareholder reports and quarterly portfolio holdings online, unless a shareholder elects to receive paper copies via mail. Currently, funds can deliver periodic shareholder reports electronically only if a shareholder has affirmatively requested such form of delivery. Funds would be able to rely on the Rule immediately after the effective date but would have to provide shareholders 60 days' advance notice that they intend to rely on the Rule.

SEC Focus on Enhanced Derivatives Disclosures and Quantitative Measurements of Risk Metrics

The Proposed Amendments are a result of the SEC's ongoing effort to strengthen its ability to identify and address risks in the asset management industry. In a December 2014 speech, SEC Chair Mary Jo White outlined three initiatives aimed at the investment management industry: (1) expanded data reporting for funds and investment advisers; (2) enhanced controls on risks related to portfolio companies; and (3) improved transition planning and stress testing. In particular, Chair White indicated that “the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of their holdings, and their securities lending practices should all be significantly enhanced.” She noted that “[i]nadequate controls in those areas can create significant risks for funds themselves and their investors, as well as raising questions about whether there could be a potential impact on the financial system as a whole.”[2]

Use of Derivatives

In her December 2014 speech, Chair White stated that fund reporting obligations have not adequately kept pace with emerging products and strategies, noting that the SEC's “rules do not require standardized reporting for many types of derivatives used by funds today. This is a clear gap, particularly given the growth in the volume and complexity of derivatives used by funds.” The SEC states in the Release that the increased use and complexity of derivatives, as well as the popularity of so-called “alternative” funds, has led it to “create a more detailed, uniform, and structured reporting regime for derivatives.”

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Form N-PORT would require a fund to disclose certain characteristics and terms of each derivatives contract, as well as the exposures the derivatives create or hedge in the fund, including exposures to currency fluctuations, interest rate shifts, prices of the underlying asset, and counterparty credit risk. Funds would be required to report detailed information regarding their use of derivatives, including the category of derivative (*e.g.*, forward, future, option, etc.), the identity of the counterparty, and the relevant terms and conditions of each derivative (*e.g.*, payoff profile and a description of the underlying reference instrument). Form N-PORT would also require funds to report the delta of an option, which is the ratio of the change in the value of the option to the change in the value of the reference instrument. Form N-PORT would also require funds to report monthly net realized gain or loss, and net change in unrealized appreciation or depreciation, attributable to certain derivatives (including commodity contracts, credit contracts, equity contracts, foreign exchange contracts, and interest rate contracts).

In addition, the proposed amendments to Regulation S-X would require new, standardized disclosures in financial statements regarding fund holdings. Regulation S-X currently does not prescribe specific information for most types of derivatives. Such proposed disclosures would now include fund holdings in open futures contracts, open forward foreign currency contracts, and open swap contracts, and additional disclosures regarding fund holdings of written and purchased option contracts. The proposed amendments would also require that such disclosures be placed prominently in the financial statements, rather than in the notes, per the current requirement.

Quantitative Measurements of Risk Metrics

Proposed Form N-PORT would require reporting of certain quantitative measurements of risk metrics not previously reported by all funds. Unlike financial statements, which are backward-looking and static, the quantitative measurements of risk metrics data are forward-looking and measure data over a range of potential scenarios. In the Release, the SEC notes such risk metrics are intended to quantify the more narrative and qualitative disclosures about fund investment strategies and risks included in fund registration statements, and are intended to assist the SEC in anticipating and preventing issues related to such risks.

Form N-PORT would require funds to disclose data on a portfolio-level basis, as well as on position-level bases, with respect to their exposure to particular types of investments (*e.g.*, debt securities, repurchase and reverse repurchase agreements, and securities lending transactions). The new information to be collected would measure a fund's exposure and sensitivity to changing market conditions, such as changes in asset prices, interest rates, credit spreads, and market volatility, as well as assess liquidity risks and counterparty risks in relation to such changing market conditions. In addition, such risk metric calculations also may assist the SEC in assessing to what extent a fund's exposure to price movements is leveraged through borrowings or derivatives.

Form N-PORT would require a fund that invests in debt instruments, or in 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. For both duration and spread duration, the SEC proposes to require that funds provide the change in value in the fund's portfolio from a 1 basis point change in interest rates or credit spreads.

The SEC also proposes to require disclosure of risk measures at the investment level for options, as discussed above, and convertible bonds. Funds would be required to disclose for each convertible security the conversion ratio, information about the asset into which the debt is convertible, and the delta (*i.e.*, the ratio of the change in the value of the option to the change in the value of the asset into which the debt is convertible).

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Funds would be required to provide position-level information regarding their counterparties with respect to securities lending, repurchase agreements and reverse repurchase agreements, as well as over-the-counter derivatives transactions. The SEC would use the data to assess both individual and multiple fund exposures to a single counterparty.

Form N-PORT also would require information about liquidity risk by, for example, requiring funds to provide information about the market liquidity and pricing of portfolio investments, as well as information regarding fund flows, which is intended to highlight liquidity pressures a fund might experience due to redemption activity.

In addition to the information required by Form N-PORT, in the Release, the SEC noted that "the additional census-type information not currently collected by Form N-SAR would improve the [SEC] staff's ability to carry out regulatory functions, including risk monitoring." Regulation S-X, as proposed, would also now require disclosure regarding liquidity of investments.

This focus on quantitative measurements of risk metrics is part of a larger regulatory movement. For example, the Proposed Amendments are preceded by the SEC's 2014 MMF reforms, which impose new controls to address risks to investors and the financial system at large, as well as the SEC's publication of its guidance "Risk Management In Changing Fixed Income Market Conditions" in January 2014, which recommended certain risk analytics, such as stress testing of liquidity and other scenarios and risk assessment, as best practices for fixed income funds.

To read the full alert, please click here.

Notes:

[1] *See* Investment Company Reporting Modernization, Release No. IC-31610 (May 20, 2015), available at http://www.sec.gov/rules/proposed/2015/33-9776.pdf (the "Release"). The SEC also proposed additional changes to Form ADV and related reporting by investment advisers, which are summarized here.

[2] *See,* Mary Jo White, Chair, Securities and Exchange Commission, Address at The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014).

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