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Investment Management Alert

The SEC's Proposed Reporting and Disclosure Changes: What Investment Companies and Advisers Should Know

On May 20, 2015, the Securities and Exchange Commission ("SEC") issued a release proposing new rules and forms and amendments to existing rules and forms that would affect registered investment companies (the "Investment Company Proposal").[1] In a companion release, the SEC proposed amendments to an existing form and rules that would affect investment advisers (the "Investment Adviser Proposal").[2] These two Proposals are intended to modernize and enhance disclosures for the investment management industry. Additionally, the Proposals would further the SEC's use of technology in its efforts to monitor risks as the primary regulator of registered investment companies and registered investment advisers.

The SEC indicated that these Proposals are a result of the growth of new and increasingly complex investment products and strategies. Additionally, the Proposals seek to take advantage of technological advances in data collection and analysis.

I. Investment Company Proposal

The Investment Company Proposal seeks to (1) enhance the transparency of investment company portfolios and investment practices both to the SEC and to investors, (2) take advantage of technological advances in the reporting of information to the SEC and in providing information to existing and potential investors, and (3) reduce duplicative or unnecessary reporting burdens. The principal features of the Investment Company Proposal are summarized below.

Form N-PORT and the Rescission of Form N-Q

The SEC has proposed to rescind Form N-Q and to adopt a new portfolio reporting form, Form N-PORT, which would require all registered investment companies (other than money market funds and small business investment companies ("SBICs")) and unit investment trusts that operate as exchange-traded funds to report portfolio information in Extensible Markup Language ("XML") format to the SEC.[3] The reports on Form N-PORT would be filed with the SEC on a monthly basis (no later than 30 days after the end of each month), with every third month's report available to the public 60 days after the end of a fund's fiscal quarter. In addition to a fund's complete portfolio holdings, Form N-PORT would also require information relating to (1) derivative investments and certain risk metric calculations that would measure a fund's exposure to and sensitivity to changes in market conditions, such as changes in asset prices, interest rates or credit spreads; (2) a fund's monthly returns; (3) certain fund activities, such as securities lending, repurchase agreements and reverse repurchase agreements, including information about the counterparties to which the fund is exposed in such transactions as well as in over-the-counter derivative transactions; and (4) fund liquidity risk and pricing of portfolio investments.[4]

The SEC believes that the adoption of Form N-PORT will enable it to further its mission to protect investors by assisting its staff in carrying out regulatory responsibilities, including the examination, enforcement and monitoring of funds, the formulation of policies, and the review of fund registration statements and disclosures. In addition, the SEC believes that the information to be provided in Form N-PORT will be beneficial to investors and other potential users.

Form N-CEN and the Rescission of Form N-SAR

In addition to Form N-PORT, the SEC is also proposing a new annual reporting form, Form N-CEN, which would replace Form N-SAR as the SEC's method to collect

1 *See Investment Company Reporting Modernization*, Securities Act Release No. 9776, Securities Exchange Act Release No. 75002 and Investment Company Act Release No. 31610 (May 20, 2015), http://www.sec.gov/rules/proposed/2015/33-9776.pdf.

2 *See Amendments to Form ADV and Investment Advisers Act Rules*, Investment Advisers Act Release No. 4091 (May 20, 2015), http://www.sec.gov/rules/proposed/2015/ia-4091.pdf. The Investment Adviser Proposal would affect investment advisers registered with the SEC. The SEC states in the Proposal that it understands that state securities authorities intend to consider similar changes that will affect investment advisers registered with states, who are required to complete Form ADV Part 1B as part of their state registration.

3 Money market funds report monthly portfolio information on Form N-MFP, and thus, the SEC has not proposed Form N-PORT apply to money market funds. SBICs are not required to file a Form N-Q.

4 Form N-PORT also would define an "illiquid asset" as "an asset that cannot be sold or disposed of by the Fund in the ordinary course of business within seven calendar days, at approximately the value ascribed to it by the Fund." This definition is the same definition used in the liquidity guidance issued by the Commission for open-end funds. *See Revisions of Guidelines to Form N-1A*, Securities Act Release No. 6927 and Investment Company Act Release No. 18612 (Mar. 12, 1992), https://www.sec.gov/divisions/investment/1992/33-6927.pdf. The SEC states in the Investment Company Proposal that the Division of Investment Management is considering a recommendation to update liquidity standards for open-end funds and exchange-traded funds, which may result in updated liquidity guidance.

census information from investment companies. Form N-CEN would be filed in XML format and would include many of the items included in Form N-SAR, but would replace those items believed to be outdated or of limited usefulness with items believed by the SEC to be of greater relevance.

New information required to be disclosed in Form N-CEN includes, but is not limited to: (1) fund directors' names and information about other registered investment companies for which they serve as director; (2) information about the fund's chief compliance officer; (3) whether the fund received financial support from an affiliate; (4) whether the fund relied on any exemptive orders from the Investment Company Act of 1940 (the "1940 Act"), the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the "1934 Act"); (5) whether the fund reprocessed accounts or made any payments to shareholders as a result of a NAV error; and (6) whether the fund issued any distributions or dividends accompanied by a written statement pursuant to Section 19(a) of the 1940 Act.

Form N-PORT would also require specific information dependent on the type of registrant, *i.e.*, management investment companies, closed-end companies and SBICs, exchange-traded funds, and exchange-traded managed funds (including those organized as unit investment trusts) and unit investment trusts. For example, new information required to be provided by management investment companies includes, among other things: (1) information on the classes of shares offered by a fund; (2) whether the fund is non-diversified; (3) whether the fund invests in a controlled foreign corporation and information about such corporation; (4) information regarding the fund's securities lending program; (5) information as to reliance on certain additional rules under the 1940 Act (*i.e.*, Rules 15a-4 and 17a-8); (6) whether the fund had an expense limitation agreement in place and whether any expenses were reduced or waived and subject to recoupment during the period; and (7) disclosure of any payments for brokerage and research services.

Under the Investment Company Proposal, Form N-CEN would be required to be filed annually by all registered investment companies, except face amount certificate companies (that are not currently required to file reports on Form N-SAR).[5] The SEC is proposing a filing period of 60 days after the end of a fund's fiscal year. Amendments to previously filed Form N-CENs would be permitted throughout the year, but filers would be required to submit a complete form as an amendment. Form N-CEN would not be permitted to cover periods longer than 12 months. Filers changing their fiscal year would need to file a Form N-CEN for a period shorter than one year.

The SEC believes that in implementing content and format requirements for census reporting by adopting Form N-CEN, it will be better able to carry out its regulatory functions, while at the same time reduce burdens on filers.

5 Wholly owned subsidiaries of investment companies would not be required to file Form N-CEN if all the financial information with respect to the subsidiaries is reported on the parent company's Form N-CEN.

Amendments to Regulation S-X

The SEC is also proposing amendments to Regulation S-X that would align a fund's financial statement disclosures, particularly with respect to derivatives, to those items required by proposed Form N-PORT, in a more "human readable" format. The proposed amendments to Regulation S-X would:

- Require new, standardized disclosures regarding fund holdings in open futures contracts, open forward foreign currency contracts and open swap contracts, and additional disclosures regarding fund holdings in written and purchased options contracts;
- Update the disclosures for other investments as well as reorganize the format in which some investments are presented;
- Amend the rules regarding the general form and content of fund financial statements;
- Require prominent placement of disclosure regarding investments in derivatives in the financial statements, rather than in the notes to the financial statements; and
- Require new disclosure in the notes to the financial statements regarding a fund's securities lending program.

The proposed amendments will renumber the current schedules in Article 12 of Regulation S-X and break out disclosure of derivatives currently represented in Article 12-13 into separate schedules.

In addition to amending and adding schedules to Regulation S-X and making amendments to related rules, the Proposal would make certain amendments to Rules 12-12 through 12-12C dealing with disclosure of investments in securities of unaffiliated issuers. The amendments provide for:

- Categorization of schedule of investments by type of investment, country or geographic region and industry;[6]
- Disclosure of interest rate or preferential dividend rate and maturity date for certain debt securities, along with referenced rate and spread for variable rate securities;
- Disclosure of the in-kind interest rate for securities with payments in-kind;
- Identification where any portion of security is on loan;
- Identification of securities with values determined using significant unobservable inputs (categorized as Level 3 Securities pursuant to Accounting Standards Codification Topic 820, Fair Value Measurement);

6 Funds are currently required to categorize investments by industry, country or geographic region.

- Identification of illiquid securities; and
- Modifications to the presentation of securities sold short, to provide relevant similar information as that described in the proposed derivatives disclosures.

The SEC is also proposing to amend Rule 12-14 of Regulation S-X and the rules and schedules dealing with disclosure of a fund's investments in and advances to affiliates. The amendment would require a fund to disclose *the net realized gain or loss for the period* and the *net increase or decrease in unrealized appreciation or depreciation for the period* for each affiliated investment. A fund would also be required to disclose the *total realized gain or loss* and *total net increase or decrease in unrealized appreciation or depreciation* for all affiliated investments.

The SEC is proposing to amend Article 6 of Regulation S-X, which prescribes the form and content of financial statements filed for funds. Many of the proposed amendments to Article 6 would align it with the various proposed amendments to Article 12.

Option for Website Transmission of Shareholder Reports

The Investment Company Proposal would also add new Rule 30e-3 under the 1940 Act to permit, but not require, investment companies to satisfy their annual and semi-annual shareholder report delivery obligations under the 1940 Act by making shareholder reports available on the investment company's website.[7] The Proposal includes conditions for reliance on the new rule relating to: (1) the availability of the shareholder report and other required information; (2) prior shareholder consent; (3) notice to shareholders of the availability of shareholder reports; and (4) the ability for shareholders to request paper copies of the shareholder report and other required information.

Availability of the Shareholder Report and Other Materials. A fund must be able to meet the availability requirements set forth in the Investment Company Proposal in order for a shareholder report to be considered transmitted to shareholders. The following is a summary of those requirements:

- Shareholder reports must be publicly accessible, free of charge, and at a specified website.[8] Accessibility must begin no later than the date of transmission in reliance on proposed Rule 30e-3 and ending no later than the date when the fund next "transmits" a report required by Rule 30e-1 or Rule 30e-2;
- A fund must also post on the same website any previous shareholder report transmitted to shareholders within the last 244 days (*e.g.*, the fund's most recent annual or semi-annual report, as the case may be) and its complete schedules of portfolio holdings as of the most recent first and third fiscal quarters (within 60 days after the close of such fiscal quarters);[9]
- Persons accessing the materials would have to be able to permanently retain (free of charge) an electronic version of the materials; and
- A fund should have reasonable procedures in place to take advantage of any safe harbor for non-compliance (*e.g.*, because of some technical issue, natural disaster, etc.).

Shareholder Consent. Electronic transmission to a shareholder would be permitted only if the shareholder has previously consented—either expressly or through implied consent—to electronic transmission. To rely on implied consent, the fund must transmit a statement to the shareholder at least 60 days prior to its reliance on Rule 30e-3. The statement must notify the shareholder of the fund's intent to make future shareholder reports available on the fund's website until the shareholder revokes consent.[10] The statement must be in plain English and contain the following:

- A statement that shareholder reports will be available free of charge at a website and that the fund will no longer mail printed copies unless the shareholder notifies the fund that he or she wishes to receive printed shareholder reports;[11]
- A statement that the fund will mail printed copies of future shareholder reports within 30 days after the fund receives notice of the shareholder's preference; and
- A prominent legend in bold-face type that states: "How to Continue Receiving Printed Copies of Shareholder Reports."

Notice Requirement. A fund would be required to send a notice within 60 days of the close of the fiscal period to shareholders who have consented to electronic transmission.[12] The notice must be filed with the SEC within 10 days after being sent to shareholders. The notice must be in plain English and contain the following:

7 The proposed rule would not be available to funds relying on Rule 30e-1(d) under the 1940 Act to utilize statutory prospectuses or statements of additional information in place of shareholder reports. Additionally, funds that use a summary schedule of portfolio investments in their financial statements pursuant to Rule 12-12C of Regulation S-X would not be able to rely on Rule 30e-3 for electronic transmission of their shareholder reports.

8 All materials a fund posts on its website in order to meet this availability requirement must be in a format that is convenient for reading online and for printing on paper.

9 This requirement does not apply to money market funds and SBICs because money market funds are currently required to post certain portfolio holdings and other information on their websites pursuant to Rule 2a-7 under the 1940 Act, and because SBICs are not currently required to file reports on Form N-Q, nor would SBICs be required to file reports on Form N-PORT.

10 A single statement may be sent to shareholders who share an address, as long as the statement is addressed to all shareholders individually or as a group.

11 To facilitate shareholders' notice to a fund of their desire to receive printed shareholder reports, the fund must include a toll-free telephone number and a postage-paid reply form with directions for the shareholder to use either of those two methods to notify the fund of his or her desire to receive printed shareholder reports.

12 Notices could not be incorporated into or combined with any other document, or sent along with any other shareholder communications (other than the fund's current summary prospectus, statutory prospectus, statement of additional information or notice of internet availability of proxy materials).

- A prominent legend in bold-face type stating that an important report to shareholders is available online and in print by request;
- A statement that each shareholder report contains important information about the fund, including its portfolio holdings, and is available on the Internet or, upon request, by mail, and encouraging shareholders to access and review the report; and
- A website address that leads directly to each report and other required portfolio information the fund is transmitting, along with instructions on how a shareholder may request, at no charge, a paper copy of the materials.

Delivery Upon Request. A fund that relies on Rule 30e-3 for electronic transmission would be required to send at the request of any person, at no cost to such person, and within three days, a paper copy of any of the materials posted on its website in reliance on Rule 30e-3.

Related Disclosure Amendments. A fund that wishes to send its initial statement or notice regarding its reliance on Rule 30e-3 (described above under "Shareholder Consent Requirements" and "Notice Requirement") with its summary prospectus or notice of internet availability of proxy materials would be required to include as part of the legend on the cover page of such documents the website address required to be included in the notice. Additionally, the SEC proposes to amend Rule 498 under the 1933 Act and Rule 14a-16 under the 1934 Act to allow the statement or notice to accompany and have equal or greater prominence than the summary prospectus or notice of internet availability of proxy materials.

Proposed Compliance Dates

The proposed compliance dates for amendments discussed in the Investment Company Proposal and summarized herein vary in relation to each group of amendments:

Form N-PORT and the Rescission of Form N-Q. If Form N-PORT is adopted, the SEC expects to provide for a tiered set of compliance dates based on asset size. It is expected that funds that, together with other investment companies in the same "group of related investment companies" (as defined in Rule 0-10 under the 1940 Act), with net assets of $1 billion or more as of the end of the most recent fiscal year would first file Form N-PORT 18 months after the effective date. All other entities would first file Form N-PORT 30 months after the effective date.[13]

Form N-CEN and the Rescission of Form N-SAR. Unlike Form N-PORT, the SEC does not expect to employ a tiered compliance date for Form N-CEN. Instead, if Form N-CEN is adopted, the SEC is proposing a compliance date of 18 months from the effective date.[14]

13 The SEC expects to rescind Form N-Q with timing consistent with the proposed effective dates of Form N-PORT.

14 The SEC expects to rescind Form N-SAR with timing consistent with the proposed effective date of Form N-CEN.

Amendments to Regulation S-X. The SEC is proposing a compliance date of 8 months from the effective date for the amendments to Regulation S-X.

Option for Website Transmission of Shareholder Reports. The SEC believes that because proposed Rule 30e-3 is permissive, and would not require funds to transmit their shareholder reports via electronic transmission, funds should be able to rely on Rule 30e-3 immediately after the effective date.

II. Investment Adviser Proposal

The Investment Adviser Proposal seeks to amend Form ADV to (1) require investment advisers to provide information related to their separately managed account ("SMA") business; (2) enable private fund investment advisers to file an "umbrella registration" for separate investment advisers that operate as a single investment advisory business; and (3) make certain clarifying, technical and other amendments. Additionally, the Investment Adviser Proposal seeks to amend Rule 204-2 under the Advisers Act, the books and records rule, and to make various technical and clarifying amendments to other rules under the Advisers Act. The principal features of the Investment Adviser Proposal are summarized below.

Proposed Amendments to Form ADV

Information Regarding SMAs. Many of the proposed amendments to Form ADV are designed to assist the SEC in collecting information specific to investment advisers' SMAs, thereby enhancing the SEC staff's ability to effectively carry out its risk-based examination program and other risk assessment and monitoring activities.[15] The data collection focuses on types of assets held and the use of derivatives and borrowings in SMAs. The proposed changes are as follows:

- Investment advisers would be obligated to indicate the percentage of SMA assets in 10 broad asset categories (*e.g.*, exchange-traded equities, U.S. Government and agency bonds, securities issued by investment companies and derivatives). This information would be provided annually. Investment advisers with SMA assets under management of $10 billion or more would be required to include both annual and semi-annual data in the annual filing.
- All investment advisers with SMA assets under management would be required to report the percentage of SMA assets invested in derivatives.
- Investment advisers with $150 million in SMA assets under management would be required to report information on the use of borrowings and derivatives in SMAs:

15 For the purposes of reporting on Form ADV, the SEC considers SMAs to be all advisory accounts other than registered investment companies, business development companies, and pooled investment vehicles that are not investment companies (*i.e.*, private funds).

- Investment advisers with $150 million but less than $10 billion in SMA assets under management would be required to 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; and

- Investment advisers with $10 billion or more in SMA assets under management would be required to report the gross notional exposure and weighted average amount of borrowings (as a percentage of net asset value) as well as the weighted average gross notional value of derivatives (as a percentage of net asset value) in each of six specific derivatives categories.[16]

- Investment advisers would be required to update their borrowing and derivatives information annually when filing their annual updating amendment to Form ADV, and those with at least $10 billion in SMA assets under management would be required to report mid-year and annual borrowing and derivatives information as part of their annual filing.

- Investment advisers would be required to identify custodians that hold at least 10% of their SMA assets under management along with the amount of assets held at those custodians.

Additional Information Regarding Investment Adviser and Advisory Business. The Investment Adviser Proposal includes additional amendments to Form ADV to elicit information regarding the investment adviser and its business operations and affiliations. These amendments are designed to enhance the SEC's understanding and oversight of investment advisers and to assist the SEC staff in its risk-based examination program. The additional information that the SEC would collect includes, but is not limited to, the following:

- The addresses of the investment adviser's website(s) and all social media accounts and marketing platforms, including Twitter, Facebook and LinkedIn;

- The total number of offices at which the investment adviser's advisory business is conducted, along with the locations of the investment adviser's 25 largest offices and their respective CRD branch numbers;

- The number of employees who performed advisory functions from the investment adviser's 25 largest offices, and an indication of each of the 25 largest offices' other investment-related business operations;

- Whether the investment adviser's Chief Compliance Officer ("CCO") is compensated or employed by any person other than the investment adviser or a related person of the investment adviser (*e.g.*, outsourced CCO services);

- An indication, within a range, of the investment adviser's own assets;

- Information related to the number of the investment adviser's clients and the amount of regulatory assets attributable to regulatory accounts (e.g., registered investment companies, business development companies and all parallel managed accounts), assets under management in non-U.S. regulatory accounts, and the number of non-regulatory accounts;[17]

- Detailed information regarding the total amount of regulatory assets under management attributable to acting as a sponsor and/or portfolio manager of a wrap fee program, and the name, SEC file number and CRD number of sponsors of wrap fee programs for which the investment adviser serves as portfolio manager;

- The percentage of each private fund owned by qualified clients, as defined in Rule 205-3 under the Advisers Act; and

- The identifying numbers of financial industry affiliates of the investment adviser (*e.g.*, Public Company Accounting Oversight Board ("PCAOB") registration numbers and CIK numbers).

Umbrella Registration. The proposed amendments to Form ADV would also allow multiple private fund investment advisers that operate as a single investment advisory business to register with the SEC under "umbrella registration" on a single Form ADV. Currently, a number of private fund investment advisers rely on the guidance in the SEC no-action letter to the American Bar Association (the "ABA Letter"), which imposes a number of conditions on investment advisers wishing to rely on the registration of an affiliated investment adviser.[18] Many of the changes to Form ADV to accommodate umbrella registration codify the relief granted in the ABA Letter. The conditions for umbrella registration include the following:

- The filing investment adviser and one or more relying investment advisers conduct a single private fund advisory business and each relying adviser is controlled by or under common control with the filing investment adviser;

- The filing investment adviser and each relying investment adviser advise only private funds and clients in separately managed accounts that are qualified clients (as defined in Rule 205-3 under the Advisers Act) and are otherwise eligible to invest in the private funds advised by the filing investment adviser or a relying investment adviser and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds;

- The filing investment adviser has its principal office and place of business in the United States;

- Any relying investment adviser and its employees are supervised and controlled by the filing investment adviser, such that the relying investment adviser and its employees are "persons associated with" the filing investment adviser as defined in the Advisers Act;

16 *See* the Glossary to Proposed Form ADV for the definition of "gross notional value," "borrowings" and "net asset value."

17 For the purpose of calculating regulatory accounts and regulatory assets under management, investment advisers should review the proposed Form ADV, Part 1A, Instruction 5.b., which is available at http://www.sec.gov/rules/proposed/2015/ia-4091-appendix-b.pdf.

18 *See* American Bar Association, Business Law Section, SEC No-Action Letter (Jan. 18, 2012), available at http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm.

- The advisory activities of each relying investment adviser are subject to the Advisers Act and the rules thereunder, and each relying investment adviser is subject to examination by the SEC; and
- The filing investment adviser and each relying investment adviser operate under a single code of ethics adopted in accordance with Rule 204A-1 under the Advisers Act and a single set of written policies and procedures adopted and implemented in accordance with Rule 206(4)-(7) under the Advisers Act and administered by a single CCO in accordance with that rule.

The SEC has also proposed a new Schedule R to Form ADV, which would include detailed information regarding the ownership structure of each relying investment adviser. Additional amendments to the instructions and Glossary of Form ADV would be made to reflect the umbrella registration amendment. Umbrella registration would not be available for exempt reporting investment advisers.

The proposal also includes clarifying and technical amendments to Form ADV and its instructions. The SEC believes that the proposed technical and clarifying amendments would make the filing process clearer and more efficient for investment advisers, thus increasing the reliability and consistency of information provided by investment advisers.

Proposed Amendments to Advisers Act Rules

Proposed Amendments to Books and Records Rules. The proposed amendments would tighten certain recordkeeping obligations under Advisers Act Rule 204-2. The proposed amendment to Rule 204-2(a)(16) would require an investment adviser to maintain records supporting performance claims in communications that are distributed or circulated to *any person*. Currently, an investment adviser is required to maintain such records of communications distributed or circulated to 10 or more persons.

Additionally, the proposed amendment to Rule 204-2(a)(7) would broaden the recordkeeping obligations of an investment adviser to maintain original records of all written communications received and copies of all written communications that are sent related to the performance or rate of return of any or all managed accounts or investment recommendations. Investment advisers are currently only required to maintain records of correspondence that fall into certain categories.

Proposed Technical Amendments to Advisers Act Rules. The SEC has proposed additional technical amendments to several rules under the Advisers Act, removing transition provisions where the transition process is complete, as well as the withdrawal of transition Rule 203A-5 under the Advisers Act. Most of these transition provisions were added as part of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Submission of Comments

Interested persons may submit written comments on the Investment Company Proposal and the Investment Adviser Proposal and any other matters that might have an impact on the Proposals. Comments must be received on or before August 11, 2015.