

SRZ Submits Commentary on SEC ADV & IAA Proposals

Concerns over consistency and confidentiality

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SEC proposals (Amendments to Form ADV and Investment Advisers Act Rules) have been closely reviewed by Schulte Roth & Zabel LLP (SRZ), in its comment letter. With offices in New York, London and Washington, D.C., SRZ has a leading investment management practice and is one of only a few firms with a dedicated group of lawyers specifically focusing on regulatory and compliance matters within its hedge fund practice.

We outline SRZ's concerns in three key areas of the proposals: public disclosure of reporting for separately managed accounts (SMAs); restrictions on use of umbrella ADV reporting; and one important omission in the proposals. We also touch on some additional feedback that trade associations have given to the SEC, in their own comment letters.

Regulatory reporting for separately managed accounts

In Europe, managed accounts can be outside the scope of AIFMD and associated regulatory reporting. In the United States, SMA advisers may already report to the CFTC and could soon need to carry out regulatory reporting to the SEC, as do private and public funds; the SEC seems to define an SMA as any advisory account that does not fall into three "pooled investment vehicle" buckets – private funds, Registered Investment Companies (RICs) and Business Development Corporations (BDCs). SRZ's comment letter alerts the SEC to the risk that part of the proposals could represent radical departures from previous SEC, and other regulators', assurances over the protection of commercially confidential information.

Marc E. Elovitz, a New York-based SRZ partner who chairs the firm's Investment Management Regulatory & Compliance Group, explains, "Private funds make disclosures of investment information in Form PF, which is kept confidential as the information is recognised as proprietary and sensitive. The context here is that Dodd-Frank rules require



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the private fund disclosures for monitoring systemic risk and reporting to the Financial Stability Oversight Council (FSOC)." SRZ also points out that analogous reports to the CFTC, such as CPO-PQR, and CTA-PR, which can relate to funds or managed accounts or both,

are confidential. Now the SEC is proposing similar disclosures from SMAs – but not for systemic risk monitoring. The SEC wants this information for its own purposes, in relation to risk-based examinations and assessments. The agency proposes to gather the data via Form ADV, which has historically been largely publicly visible. SRZ has no issue with the SEC or other regulators requesting the data, but stresses that the information should be kept confidential. Indeed, some parts of Form ADV Part 1A are already non-public.

The SEC proposal for public disclosure of assets in ten asset classes, gross notional exposures in general and for six types of derivatives, was very surprising to SRZ, which thinks public disclosure would be at variance with previous assurances of confidentiality, such as amendments to the Advisers Act Section 204(b)(10) and the Form PF Steering Committee guidelines. Further, SRZ does not see the SEC as pursuing any broad drive towards a wholesale, disruptive change in disclosure requirements: "This proposal seems to be isolated. There was no indication in the proposing release that they view public disclosure as being meaningful or useful," Elovitz notes, and he thinks it would be very easy to keep this very fund-specific information confidential. Simultaneously to its proposals for ADV and IAA, the SEC has made separate and different proposals on RIC and BDC reporting entitled *Investment Company Reporting Modernization*. This document seems to echo SRZ's comment letter, in acknowledging that "copycatting" and "front running" are arguments against greater or more frequent disclosures. As well Elovitz argues that the 13F disclosure (of calendar quarterly equity positions with a 60-day time lag) is "very different from the proposed SMA disclosures. The 13F covers only long positions whereas the SMA disclosures would require some disclosure of short exposures." In the United States, funds need not disclose shorts, and SRZ argues short disclosures (as required in some European markets) raise the risk of "short squeezes."

Requiring SMAs to publicly report data that is kept confidential by private funds seems especially messy given that “many SMAs pursue similar, and sometimes identical investment strategies to private funds when there is a *pari passu* requirement,” states New York SRZ partner Brian T. Daly, who advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. “The government agrees that trade secrets should not be publicly disseminated, so this would translate protected data into non-protected information,” underscores Daly. Outside the United States, it is also normal for this type of fund reporting to be confidential: AIFMD Annex IV reports to member state regulators in Europe are not publicly disclosed, and Daly thinks Annex IV is broader in scope, in some ways, than Form PF.

The proposals raise client confidentiality, as well as adviser confidentiality, concerns, according to trade associations the Managed Funds Association (MFA), Alternative Investment Management Association (AIMA) and the Investment Adviser Association (IAA). The proposed disclosures could allow the public to draw inferences about the identity of, or investment strategies pursued by, particular clients; aggregating the data does not necessarily resolve this concern if there is known to be one or a dominant client(s). This could be inconsistent with other rules, such as Section 210(c) of the Investment Advisors Act of 1940, which aims to protect “the identity, investments or affairs” of clients.

Elusive harmonization

So, it seems the proposals are inconsistent with other SEC rules and guidance. They may also deviate from the rules of other US regulators, such as the CFTC and FSOC. The SEC clearly states that its rulemaking proposal is “independent of the FSOC,” showing the demarcation amongst US regulators. To divorce the proposed SMA disclosures from other regulatory reporting requirements would be disappointing when there had been some piecemeal degree of harmonisation between Form PF and CFTC reports. Daly says, “Many managers that are dually registered with SEC

and CFTC need to send regulatory reports to both, and from the get go there was some ability to file one in full and satisfy the other on a short form by reference to the other.” Daly admits that CTAs have slightly different reporting requirements, such as footnotes 9, 10 and 11, but there is still a decent overlap. As many of these firms may also need to start reporting SMA data, via Form ADV, as well as different reports for BDCs and RICs, there seems to be a growth industry in US reporting standards, not to mention those overseas. Alignment amongst the reporting standards would be appreciated.

Still, Daly does empathize with the volume of work faced by the agency. “They have a lot of work on their plate with lots of Dodd-Frank regulations still to implement,” he observes. And the US currently has no body to promote harmonisation amongst regulatory agencies. Explains Daly, “The various forms have different purposes – financial stability, oversight and reviews by prudential regulators,” and resource constraints make it difficult to harmonize everything. He recognizes that “formal rule making takes a lot of time and resources as there has to be an opportunity for making comments.” Politically, “if one regulator is perfectly happy with their forms, they will not give ground and end up with a less than optimal form for the sake of harmonizing,” he thinks. But even if complete harmonization looks like a holy grail, overt conflicts with other rules should be avoided.

Umbrella ADV reporting

Moving on to another of the SEC’s proposed rulemaking changes, umbrella ADV reporting has, in effect, been around for a decade. Triangulating amongst multiple ADV filings from the same manager can become an awkward jigsaw puzzle when Form ADV was originally designed for a single entity and a “1970s world,” says Daly, so the concept of adding a Schedule R to Part 1A could be useful. Formalizing the general principle of umbrella, or consolidated, firm-wide filings (which have been allowed since 2005, with guidance refined in 2012) is welcome. Umbrella reporting benefits all stakeholders – regulators,

managers, investors and potential investors – by making the data more accessible, digestible, meaningful and comparable. But it could be a backward step if the non-US advisers, and those not fully registered, can no longer avail of umbrella ADVs, as the SEC proposes.

SRZ, and AIMA, are adamant that the advantages of more holistic reporting should be on offer to both US and non-US registered and headquartered firms. To prevent foreign managers that are not fully registered from utilising the umbrella provisions makes their disclosures “more difficult, fractured and less complete, which would be a very negative result,” says Daly. SRZ recognises that the SEC’s intention is to prevent ‘regulatory arbitrage’ whereby US managers could circumvent the Advisers Act for non-US clients, by choosing a non-US entity as filing adviser. But SRZ thinks that other, better, criteria for registration already exist to prevent this. “The concept of operational independence currently exists and the SEC has long said that the same people, business, facilities and premises are all one business,” says Daly.

Requiring non-US firms to fully register, in order to make use of umbrella reporting, is another example of inconsistency with other guidance. The SEC’s stance on extraterritoriality, which has taken the view that non-US advisers with non-US clients should not be subject to the substantive provisions of the Advisers Act, is mentioned in a footnote to the release.

This safe harbour has been documented in guidance which is “effectively considered as the law of the land even though it has not been passed by Congress.” Daly explains that because many US securities laws date back to the 1930s or 1940s, and are very broadly drafted, SEC staff regularly issues clarifications and updates. Argues Daly, “For the SEC to deviate from its own guidance would throw out of kilter international cooperation with other regulators and lead to huge uncertainty.”

Currently, non-US managers that file as Exempt Reporting Advisers (ERAs) (due to reasons

including running venture capital funds or below \$150 million of net assets managed within the US) are able to avail of umbrella reporting, under guidance for consolidated reporting, without fully registering. “A non-US adviser dealing with non-US clients has been able to stay outside of the Advisers Act,” summarises Daly and this is crucial to maintain certain commercial freedoms that are either vital to the business models of some firms or simply less costly. “It means that – for non-US clients – non-US managers can engage in principal transactions (subject to local law limitations), use custody arrangements that would not necessarily satisfy the custody rule, and have no need to do US GAAP audits,” Daly points out. The full provisions of the Advisers Act are too onerous for some managers, who would then miss out on the benefits of umbrella reporting. “Fully registering would be a very high price to pay for the benefits of aggregating regulatory filings,” argues Daly, and SRZ wants to maintain the status quo on ERA umbrella filing.

Technical and clarifying amendments

The SEC proposal states an intention of making clarifying amendments. SRZ laments that ambiguity over whether Special Purpose Vehicles (SPVs) need to register and, consequently, do regulatory reporting, has persisted throughout the 2005 and 2012 no action letters. This uncertainty is consuming a lot of time and money for advisers and SRZ suggests several possible solutions. Explains Daly, “Now that the SEC is doing plenary rule making, there is an opportunity to fix this issue once and for all. This may be a housekeeping item, but it is a far more expensive housekeeping item than one would think.”

Trade association comment letters

SRZ generally sees eye to eye with industry trade associations, such as the MFA, AIMA and IAA, which naturally share the concerns about confidentiality issues. AIMA and MFA also want ERAs to be able to continue with umbrella reporting. “The trade associations deliver a lot of value by polling their members,” says Daly, and hence, they go into a great deal of detail over the nitty gritty of reporting. Here,

we highlight three topical issues from the associations’ comment letters: thresholds for SMA reporting, measurement of leverage, and reporting of custodial exposures.

When compliance costs are growing, and can be disproportionate for smaller managers, thresholds for yet another report are important. The SEC proposes a \$150 million Regulatory Assets Under Management (RAUM) adviser-level SMA threshold for the full list of reporting and, then a \$10 million account-level SMA threshold. But the SEC still seeks some SMA disclosures from advisers running below \$150 million, whereas AIMA seeks a de minimis exemption for advisers below \$150 million of RAUM (Regulatory Assets Under Management), which would match the net asset value (NAV) threshold for private funds to complete Form PF. AIMA also wants higher minimums at both adviser and SMA level. The IAA comes up with a compelling argument: that a \$500mm adviser-level cut off point for compulsory reporting could remove 3,000 smaller advisers from reporting, whilst still giving the SEC data related to approximately 95% of industry assets. A wrinkle here is that the IAA thinks SMA reporting should be optional at the account level for SMAs of any size, simply because disaggregating those SMAs below a threshold can create more work than reporting all of them together. The MFA and IAA also raise concerns about potential duplication of reporting burdens for advisers, and sub-advisers, to SMAs.

The trade associations also disagree with the SEC proposals for derivative leverage reporting (for advisers running over \$10 billion of RAUM) to be measured using the “gross notional” method. This sounds similar, if not identical, to the AIFMD “gross” method – and the arguments against it being a meaningful measure have been very well rehearsed in relation to AIFMD over the past few years. AIMA’s 2015 submission to the European Commission, requesting a more sophisticated leverage measure, reiterates that gross notional exposure is a crude way to measure risk because it ignores netting, offsetting and economic exposure. As well, the gross notional

method fails to allow for the fact that cleared or collateralized derivatives may be less risky than those that are not. The three trade associations agree on these points and, in their comment letters to the SEC, have some suggestions for alternative measures, which would also be aligned with other regulatory reporting. Both AIMA and MFA recommend that leverage of fixed income instruments is calibrated to ten-year equivalents, to match the convention for Form PF. Netting is also allowed for in Form PF, so that firms can omit reporting those positions closed out with the same counterparty, and this refinement would be welcome.

The associations also comment on the SEC’s proposed disclosures in relation to custodian exposures and two “Efficient Portfolio Management” (EPM) techniques – security lending and repos. AIMA argues that 20% of RAUM, rather than the proposed 10%, would be a more appropriate threshold for reporting exposure to custodians. The IAA argues for a threshold of \$1 billion exposure to a custodian. The EPM proposals have parallels with ESMA’s 2012 guidelines for UCITS and ETFs in Europe. The IAA and MFA also alert the SEC to practical obstacles to gathering this data from SMA advisers: choices over custody and EPM rest with the ultimate owner of the SMA and not necessarily with the investment adviser, which might not be cognizant of these matters.

The deadline for responses to the SEC closed in August. While there is no defined timeframe for the SEC to finalise its decisions, SRZ’s Daly expects a final rule within a few months. He also thinks there could be “a phase-in period to avoid over-burdening firms that could be busy with annual reporting in early 2016.” The IAA thinks the SEC estimate of two hours’ time taken to complete each question is far too low, and suggests a 12-month transition period should be offered. [THFJ](#)

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