Talking Asset Management with KPMG

Top five challenges from the SEC derivatives rule for asset managers

The following is a transcript of Talking Asset Management with KPMG. In this episode, Sean McKee, national leader – Public Investment Management, and Matt Giordano, deputy leader – Public Investment Management, highlight the top five challenges asset managers are facing as they implement the new Securities and Exchange Commission (SEC) derivatives rule.

Transcript:

Sean McKee:

Hello, and thank you for listening to Talking Asset Management with KPMG. I'm Sean McKee, national leader for the KPMG Public Investment Management practice. I'm joined today by Matt Giordano, our deputy leader, and a former chief accountant with the SEC's division of investment management. Hi, Matt.

Matt Giordano:

Hi Sean. Great to talk to you today.

Sean McKee:

We're less than a year out from the new SEC derivatives rule and there's a lot firms need to do between now and that compliance date. What do you think are the top five challenges that asset managers are facing in implementing the rule?

Matt Giordano:

Thanks, Sean. The date is certainly getting closer and there are probably more than five challenges and there are certainly multiple derivations of each of these five challenges that I'm about to mention. The first challenge is determining the derivatives risk manager and whether that's a single person or whether it's a committee. And if you have the requisite expertise in-house.

The second is really around scoping. And what I mean by that is the determination of whether a fund falls into the limited derivative user exception or whether it doesn't. And that's actually been a lot more difficult for many advisers than I initially thought it would.

The third is around selecting the appropriate designated reference portfolio. And that includes the use of relative versus absolute VAR.

The fourth is around the use of subadvisers and getting the appropriate information. And I think getting the appropriate information can be difficult at times for a number of reasons and it's not just about this rule, but that's an area where folks are struggling a little.

And I would say last and potentially most importantly is the monitoring of the derivatives and the board reporting.

Sean McKee:

You mentioned the derivatives risk manager, and I think that's pretty interesting, because it could be an individual, it could be a committee. But you talk about the requisite experience regardless of whether you go with an individual or committee. What are you seeing as you talk to clients and other people in the industry? What are you seeing out there in terms of how people are tackling this?

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Matt Giordano:

That's a really good question. I think when it comes to the derivative risk manager, we'll see most advisers select a committee versus a single person. And that's for a number of reasons.

First and foremost, most advisers, or many advisers, don't have one person who has the requisite knowledge to pull in all the skills that are defined in the rule. And a committee suits most advisers better. What we're seeing is that they'll pull a number of folks in from different lines of the business. There may be somebody from risk, there may be somebody from operations, and there may be somebody who's connected to the trading side that's not the PM [portfolio manager], but together they bring that right skill sets.

One of the challenges around the committee is who will chair the committee and who will be the one that will report to the board. And what we're hearing is that will likely be someone on the risk side of the house because they have the deepest knowledge of the rule versus the derivatives themselves. It's more about the rule when it comes to reporting up to the board. What I've also found interesting about the committee is that there are a number of 40 Act advisers that also have an alternatives platform. Some of them are pulling folks from the alternatives platform to sit on the 40 Act Derivative Risk Manager Committee, which I think is brilliant. It's a neat way to supplement some of that expertise in-house.

Sean McKee:

That's helpful. You know, it's interesting the committee structure obviously looks like a good way to address this, given the complexity of the role and bringing more bright minds to bear, to solve the issue. Are there things other than portfolio management skill sets or risk management skill sets that you're seeing added to that committee or any other interesting constituents that you see as part of a typical committee structure?

Matt Giordano:

Yeah, I think it's bringing in SMEs as well. So, some advisers, especially the smaller advisers, may not have anybody else that'll fit that role. So, folks potentially from pricing services or outside SMEs that are nonvoting members are being pulled into the committee as well.

Sean McKee:

You mentioned also the limited derivative user exceptions. And at first glance it seemed like the scoping of whether you're in or out, or how much in or out you are in the rule would be easy, but it sounds like we're seeing complexity. What are the complexities we're seeing?

Matt Giordano:

The biggest complexity is around the hedging concept. The rule permits funds to exclude certain currency and interest rate hedges from the 10 percent derivative exposure threshold, as long as they are directly matched to specific equity or fixed-income instruments. That poses a number of challenges. And one of the challenges is the ability for the compliance folks or the risk folks to be able to tag how those derivatives are being used. What we have found is that many complexes, if they are close to that 10 percent threshold, that they're really not taking any chances. They're pulling those funds into the full VAR analysis. One of the questions that we get a lot is: what's close? If a fund has 5 percent derivative views, are you pulling it in 3 percent, 7 percent? What we're starting to see is that when you get closer to that 7 percent threshold, that funds that have 7 or more percent are really being pulled in and they're running through the full VAR analysis.

Sean McKee:

Well that makes sense. Obviously, early detection signals are always helpful. You mentioned the VAR tests and also benchmarks and reference portfolios and that the interaction of the two is one of the things we're seeing people work through. Can you talk a little bit more about that?

Matt Giordano:

What's interesting here is that the rule changed a little bit from when it was initially proposed, reproposed, and then the final rule. What I found interesting is that in this rule, the SEC basically says that a fund generally must comply with a relative VAR test unless the derivatives manager reasonably determines that the designated reference portfolio wouldn't be appropriate for the fund. And then you can use the absolute VAR. What I am guessing is that to get over that relative VAR hurdle and to get to the absolute VAR will really be tough. Most folks that we're talking to will stick to the relative VAR test. And then the second question is, when you're there, you have to ensure that you're selecting the correct designated reference portfolio or reference index. I think folks are really thinking through, do we have that correct portfolio or unlevered index? That's caused a lot of discussion. Is it too broad based? Is it based on the sector? Those are the type of questions that we're hearing around the indices.

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Sean McKee:

We obviously know a number of fund shops that use subadvisers and some to a significant extent. Obviously, the more people you have involved with the rule, the greater complexity in an operating your compliance with the rule. What are we seeing with respect to the shops that have subadvisers and how they conquer the challenge of dealing with multiple parties since they comply with the rule?

Matt Giordano:

Subadvised funds, when it comes to some of these compliance rules, are always tough, as I mentioned earlier. I think what is really important is that if you're an adviser and you have subadvised funds, whether they are wholly subadvised or whether you have sleeves, it's really ensuring that the subadviser understands what you need and how quickly you can get that information. A lot of times, a three-, four-, or five-day turnaround isn't quick enough. And one of the issues that we're seeing is that you may have a subadviser that does multiple sleeves and one subadviser doesn't know what the other subadviser is doing. So, you start to push against some of those limits when you're combining the derivatives usage. The other thing that I would say, when it comes to subadvisers, is that getting the information and aggregating the information and different information and different systems can be tough. So that's another area that we've helped our clients navigate.

Sean McKee:

Are we seeing any one-size-fits-all solutions there in terms of some people may be just saying, look, this is what we want you to report and this is what we expect you to report in this format. Or are people alternatively just dealing with each of the different formats they're getting? How are we seeing people deal with that challenge?

Matt Giordano:

I think at the end of the day, there will be some coalescence. We're still a year away from the final adoption and a lot's going to change in the next three to six months based on where everybody is now and where they want to be. A year will go by quickly and there's a lot to get through, but right now there are a number of different technology solutions that folks are using and trying to work through. It's hard to say that one's better than the other. It really depends on what derivatives you're investing in, who your service provider already is. And there's a lot to go into it.

Sean McKee:

Understood. So, significant complexity and something that actually takes quite a bit of time to work through the details if you have multiple subadvisers. Last but not least, is always one of my favorite aspects to any of this, which is the board oversight and the monitoring and reporting that they get so that they can perform that oversight. What are we seeing as the challenges there?

Matt Giordano:

I think some of this is just a board education thing as well. When we talked to certain boards, the way that this SEC rule is set up is different than others. The board is responsible for determining the derivatives manager. They're in charge of compliance with the rule under 38a-1. But they don't approve the details of the program. So sometimes it's just talking through with the board what their responsibilities are and how that differs from some of the other rules, like the valuation rule.

Now, from a monitoring standpoint or a board reporting standpoint, what we're hearing is that many of the advisers are looking for some sort of a technology solution because this information, like we talked about earlier, is in different pieces. And some of it may be on a spreadsheet here. Some of it may be from another subadviser on the other side of the house. The human capital piece of this is huge, and folks are looking for a technology solution. That's kind of the monitoring aspect or the technology piece of it.

The other piece is reporting up to the board. And what I find interesting is all boards want concise information and information that helps with oversight. But all boards are very different and want different levels of detail. I think what's important is making sure that you're working with council, with fund council, with board council, and really understanding what the board wants to see and how you can present that in a digestible manner. I think that will change from now to when the rule goes in place. And I think it'll continue to change, as I think reporting should. And you're going to understand some of these things better and understand what you want as a rule goes along.

Sean McKee:

On the technology front, are we seeing any solutions out there, are there are silver bullets? Or are you just seeing more of kind of a compilation of different systems and reports being used to facilitate the report?

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Matt Giordano:

We've helped a couple of our clients on technology solutions. There's a handful of them out there. I really think it depends on who you're currently using, how you fit into their system, and what they can provide. What I have found interesting is there are significant price differences for some of these technology solutions. And I think that that'll change. We saw that with end port and some of the other rules that came out. So that'll be an interesting item to follow.

Sean McKee:

This has been very interesting and educational. As I think about things, there's still a lot of planning needed. People should be making sure that they're having robust discussions between management, the board, the risk manager, the risk manager committee, and really working through the operational pieces of technical compliance and board reporting—a lot for people to still get done. And quite frankly, we always know this, it's not done just because you've implemented the rule. There's always ways to make it better and to improve. This will be a journey and people will learn and they will improve based upon those learnings. Very good information, Matt. Any final points before we sign off?

Matt Giordano:

Don't wait too long to do this. There's a lot to understand and there's a lot to get through. The sooner you get through it and the sooner you work with the board, the better off you'll be in the long run.

Sean McKee:

As always, if KPMG can be of any help or assistance as you go through this journey, please don't hesitate to contact us. Thanks, and have a great day.

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