Blogs
December 30, 2015
Asset Management ADVocate

Federalism, Regulatory Assets under Management ("RAUM"), and Voluntary Registration with the SEC as an Investment Adviser -- Part Three

Parts One and Two of this series identified the serious consequences of registering as an investment adviser with the SEC when you don't have the regulatory assets under management ("RAUM") required for registration by the Investment Advisers Act. This part discusses the problem of calculating RAUM when you manage portfolios that mix securities and derivatives. Unfortunately, there is no simple rule for when derivatives are included in RAUM. Rule 203A-3 under the Advisers Act provides that an investment adviser must "[d]etermine 'assets under management' by calculating the securities portfolios with respect to which [it] provides continuous and regular supervisory or management services as reported on the investment adviser's Form ADV." A client's account is considered to be a "securities portfolio," if at least 50% of the total value of that account consists of securities. The one notable exception to this "50% test" is that that *all* of the assets of a private fund (including uncalled commitments by investors) are considered to be a securities portfolio, regardless of the nature of those assets. Section 202(a)(18) of the Advisers Act defines a security in a very broad manner and, as a result, an investment (for example, a bank loan) may constitute a security under the Advisers Act, notwithstanding the fact that the same investment that may not be a "security" for purposes of other Federal securities laws. Derivatives may or may not be securities and the analysis in respect of these investments can be anything but intuitive. Nevertheless, it is important to consider the treatment of derivatives, since: 1) many investment advisers commonly use these instruments as part of their overall portfolio management; and 2) some advisers specialize in the provision of investment mandates that primarily or exclusively use derivatives (sometimes referred to as "overlay strategies"). As a general matter, none of the following derivatives are usually considered to be securities for purposes of the Advisers Act:

- Futures contracts on a stock index (e.g., S&P 500 futures);
- Credit default swaps on a broadly defined index (e.g., CDX contracts);
- Most interest rate derivatives, including interest rate swaps, LIBOR futures and Treasury futures contracts;
- Non-deliverable currency forward contracts; and
- Currency futures that trade on a futures exchange, rather than a stock exchange.

Rather, these derivatives are all subject to the jurisdiction of the Commodity Futures Trading Commission (CFTC) as "commodity interests" under the Commodity Exchange Act, instead of the jurisdiction of SEC as securities. By comparison, an option on an equity security and a forward on a security (such as a "To-Be-Announced" trade (a TBA) or other delayed delivery trades on mortgage backed securities) are securities for purposes of the Advisers Act. In conclusion, an adviser should carefully consider whether or not the derivatives used in the management of its client's portfolios constitutes a security under the Advisers Act, given the importance of the RAUM calculation under the SEC's adviser registration regime. This consideration is especially important for an adviser that relies heavily or exclusively on the use of derivatives for the implementation of a particular mandate.

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