DIVERGENT IMPACTS OF THE PROPOSED 13F RULE CHANGE - WHO ULTIMATELY WINS?

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The hedge fund industry, not exactly known for its transparency, appears as though it may soon become a bit more tight-lipped. On July 10, 2020, the SEC proposed raising the minimum filing requirement of Form 13F for the first time in 40 years from $100 million to $3.5 billion. Though the dollar increase appears significant, $3.5 billion represents proportionally the same market value of U.S. equities that $100 million represented in 1975, the year it was adopted.[1]

The original intentions of the filing requirements were to monitor the investment activities of the larger investment managers. However, with the growth of the U.S. Public Corporate Equities over the last 40 years, from $1.1 trillion to $35.6 trillion[1] and the wide range of assets under management across the large, behemoths and the seed-funded upstarts, the rule became more of an operational and compliance headache than a means of transparency. The change intends to shift the requirement back to its original purpose. The threshold will retain disclosure of over 90 percent of the dollar value of holdings data, while relieving 90 percent of the current filers, mostly relatively small managers, from the burden of having to file. The proposal will also require those who have to file to include information on all of their holdings, including holdings of fewer than 10,000 shares or less than $200,000 principal amount of convertible debt securities and less than $200,000 aggregate fair market value, which were previously exempt, therefore increasing information gathered on larger managers.[1]

To the SEC's credit, the proposed amendment includes changes to the agency's responsibility as well. To prevent such a time-lapse between adjustments, the SEC proposes the staff review the reporting threshold every five years and recommend the appropriate adjustment based on one of the adjustment methods included in the proposal. Given the hedge fund industry will continue to experience dramatic changes, we believe this is prudent.

CONFLICTING CONSEQUENCES FOR MANAGERS

What does this mean for the actual investment managers? The proposed amendments will have implications for managers with varying levels of assets under management (AUM) - small (less than $1 billion in AUM), medium (between $1-$5 billion), as well as large ($5 billion) - but, in our view, benefits smaller managers dramatically. Small and medium managers below the new threshold will benefit in two ways.

1. Decreased compliance costs for small and medium asset managers: Managers who are no longer required to file stand to save between $68 and $136 million annually in compliance costs[1]. These savings present managers the opportunity to continue to invest in core business costs, such as improving technologies.

2. Strategy opacity: The increased threshold protects smaller managers, who, according to a 2018 study, have outperformed large managers from 1994-2016[2], from having to disclose investments and inherently strategies that larger managers have the potential to imitate and hinder potentially future performance.

The proposed threshold change could potentially pose headwinds for smaller managers as well. The decrease in transparency could make it more difficult for small, well-performing funds to be discovered by asset allocators. Given the lack of data available, the resource constraints, and the general habit of following the consensus by allocators, these small funds will need to increase their investments in outbound marketing strategies. These changes will lead to increased investor acquisition costs and likely a long and arduous investment due diligence (IDD) and operational due diligence (ODD) process with asset allocators.

On the other side of the spectrum, larger managers ($5 billion-plus) will continue to be required to report information on their holdings. Though these managers will not necessarily get the benefit of reduced reporting costs or alleviate the concerns of the required transparency pose the risk of exposing strategies to competitors, larger managers are likely to benefit from the proposal. The visibility of larger managers, coupled with smaller managers' opacity, may draw more investments to larger funds as allocators may feel uncomfortable allocating to smaller, lesser-known funds. This landscape will perpetuate the "big to get bigger" skew in the market - approximately 1 percent of managers control over 70 percent of AUM[3] - while potentially increasing inbound inquiries from allocators, thus decreasing the IDD and ODD process and costs versus historical.

MUDDYING THE WATERS FOR ASSET ALLOCATORS

The potential rule change will only exacerbate the quandary which asset allocators and institutional investors wrestle with when deciding where to invest. It took conviction to take a risk on newly launched, smaller funds without the track record of larger competitors in the past. The potential removal of one source of transparency may further disincentivize finding a diamond in the rough approach, further the reliance on investment consultants, and perpetuate allocations to larger, 'safer' managers.

Given that 90 percent of current managers would no longer have to file 13F documents, the costs of ensuring proper investment and operational due diligence before investment are likely to increase.

1. No longer will allocators be able to discover fund information through the publicly filed information of the 13F. This will require different research methods to be utilized and possibly increased costs for research personnel or other resources.

2. This will also lead to an increase in both the IDD and ODD process – initially to discover potential funds to invest in, and then to also ensure fund investments meet allocators strategies without the ease of simply viewing past investments, requiring a much more manual process.

A SEA CHANGE FOR FINTECHS?

The proposed threshold amendment can fundamentally change the solution offerings of technology providers on the space and create new opportunities in terms of value proposition and services. There is currently a glut of data gathering firms who rely on the free and readily available information from 13F filings to provide estimates of historical performance, which will be losing 90 percent of their source data. But this information void for smaller hedge funds' investments creates opportunity as well.

1. Existing third-party data platforms that provide manager information for allocators, including Hedge Act, Hedge Nexus, and iCapital, would need to improve their already commoditized service offering dramatically. These platforms are already partially reliant on publicly available data, lack true pre-and-post trade analytics, are made for targeted audiences, or are sold as part of a bundle of services.

2. There is a true need in the market for a cost-efficient and objective platform that can gather performance and risk data for hedge fund managers across all AUMs, but specifically those below the $3.5 billion reporting threshold. We believe the right solution has the potential to capture both sides of the market

    a. **Allocators:** Provides the data and analytics needed to conduct lower costs investment due diligence

    b. **Managers:** A channel to be discovered, market themselves and raise new capital without the regulatory costs associated with 13F

This proposed increase in the reporting threshold for Form 13F stands to create winners and losers in the market. Asset allocators must find alternative ways to complete their due diligence and take advantage of other solutions outside of traditional filings. Any firm able to fill this transparency void places themselves in a great position to support the allocator market's population who will still invest in the small fund manager space.

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