



# Asset management accounting matters

## Overview

- Common instructions to schedules required under Article 12
- Investments in securities of unaffiliated issuers and securities sold short
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## Impact of Financial Reporting Guidance for Registered Funds and BDCs – Part II of III

### Overview

As introduced in [Part I of this series](#), the SEC adopted amendments to Articles 6 and 12 of Regulation S-X (the Amendments) that prescribe the form and content of financial statements reported by registered investment companies and business development companies. The compliance date for the Amendments is **August 1, 2017**.

The rules described herein represent the amended rules, except where specified otherwise.

Part II of this series discusses rule changes relating to:

- Investments in securities of unaffiliated issuers and securities sold short
- Open option contracts
- Investments in and advances to affiliates.

The schedules required under the Amendments are presented in the following table. The rules affected by the topics discussed in Part II are highlighted below.

Amended rules
<b>12-12 (Investments in securities of unaffiliated issuers)</b>
<b>12-12A (Investments – securities sold short)</b>
<b>12-12B (Summary of schedule of investments in securities of unaffiliated issuers)</b>
<b>12-13 (Open option contracts written)</b>
12-13A (Open futures contracts)
12-13B (Open forward foreign currency contracts)
12-13C (Open swap contracts)
12-13D (Investments other than those presented in 12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B, and 12-13C)
<b>12-14 (Investments in and advances to affiliates)</b>

Since the topics discussed in Part II do not include any newly required schedules under Article 12, Part II will only address the changes that are incremental to existing schedules.



## Common instructions to schedules required under Article 12

Changes to common instructions to schedules required under Article 12 are described as follows:

- Funds will be required to list separately investments or derivatives where key terms or characteristics differ, such as descriptions, counterparties, or contract expiration dates.
- Funds will be required to disclose the counterparty to each of their derivative transactions. However, this information will not be required for derivatives that are exchange-traded or centrally cleared.
- Funds will be required to indicate by an appropriate symbol each investment whose value was determined using significant unobservable inputs (e.g., investments classified as Level 3 in the fair value hierarchy).
- Funds will be required to indicate by an appropriate symbol each investment that cannot be sold because of restrictions or conditions applicable to the investment.



## Investments in securities of unaffiliated issuers and securities sold short

This section discusses the changes to the presentation of investments in securities of unaffiliated issuers and securities sold short in accordance with Rules 12-12, 12-12A, and 12-12B.

### *Presentation of investment subtotals*

Funds will be required to present subtotals for each category of investments (subdivided both by type of investment and by industry, country, or geographic region). In addition, the percentage of net assets that each subtotal represents should be presented.

### *Disclosures of interest terms*

Funds will be required to disclose the interest rate or preferential dividend rate and maturity date for certain enumerated debt securities. For variable rate securities, funds will be required to describe the reference rate and spread and (1) the interest rate at the end of the period for the particular investment or (2) in a note to the schedule, the rate as of the end of the period for each reference rate described in the schedule.

For securities with payment-in-kind income, funds will be required to disclose interest rates paid in kind separate from interest rates paid in cash.

### *Securities on loan*

To provide increased transparency of a fund's securities lending activities, the instructions to Rules 12-12 and 12-12B will require funds to indicate by an appropriate symbol where any portion of an issue of securities is on loan.

### *Changes to tax-basis disclosures*

As discussed in [Part I](#), the instructions to current Rules 12-12 (Investments in securities of unaffiliated issuers), 12-12C (Summary of schedule of investments in securities of unaffiliated issuers), and 12-13 (Investments other than securities) require certain tax-basis disclosures. The Amendments move these requirements to Rule 6-03(h) and require funds to present the disclosures relating to all investments, including derivatives, as a whole rather than by investment type.



## Purchased and written options

The instructions to Rule 12-13 are amended to include the following new disclosures for open option contracts written:

- Column A – Description of the contract
- Column B – Counterparty
- Column D – Notional amount.

Rule 12-13 will require funds to provide a description of the contract (which replaces the current requirement to provide the name of the issuer). This may require funds to provide more specific information to describe the risks and rewards related to the contract, such as in instances where the option contract allows for a range of underlying investments that could be delivered upon exercise.

The Amendments do not include prescriptive guidance for calculating the notional amount for option contracts. We believe a fund should consider using methods similar to those used for risk management purposes or other reasonable methods to determine notional amounts for option contracts.

Purchased options will be presented in accordance with Rule 12-12 or 12-12B. The amended instructions for those rules will require funds to apply the requirements of Rule 12-13 to disclose purchased options in a manner consistent with written options.

### ***Disclosures for options with hybrid features***

Some options contain hybrid features where the underlying investment is other than a security. For example, a swaption is an option contract where the underlying investment is typically an interest rate swap. When the underlying investment to an option would otherwise be subject to disclosure under another provision under Article 12, the description of the option should also include the description of the underlying investment as would be required by the respective provision. In the example of a written swaption, a fund would be required to include disclosures required under both Rules 12-13 (open option contracts written) and 12-13C (open swap contracts).

In the final rule release, the SEC clarified that this requirement is not intended to apply to bonds or other nonderivative instruments that contain optionality features.

### ***Disclosures when the underlying investment is an index or a basket of investments***

Some option contracts may have an underlying investment that is either an index or a basket of investments. In instances where either (1) the components to the index or basket are publicly available on a Web site as of the reporting date or (2) the components to the index or basket are not publicly available but the notional amount of the option contract does not exceed 1 percent of the net assets of the fund, the fund will only be required to identify the index or basket.

If the components of the index or basket are not publicly available and the notional amount of the option contract exceeds 1 percent of the net assets of the fund, the following disclosures are required:

- A description of the index or custom basket
- The 50 largest components in the index or custom basket
- Any other components where the notional value for the component exceeds 1 percent of the notional value of the index or custom basket.

For each investment separately listed, a fund should include the following information:

- The description of the underlying investment as would be required under Article 12
- The quantity held
- The value at the close of the period
- The percentage value compared to the net assets of the index or custom basket.



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## Investments in and advances to affiliates

The instructions to Rule 12-14 are amended to include the following new disclosures for investments in and advances to affiliates:<sup>1</sup>

- Column C – Net realized gain or loss for the period
- Column D – Net increase or decrease in unrealized appreciation or depreciation for the period.

The current instructions to Rule 12-14 require funds to disclose the amount of equity in net profit or loss for controlled companies<sup>2</sup> but do not require disclosure of realized or unrealized gains or losses. Under the amended instructions to Rule 12-14, funds will be required to disclose realized and unrealized gains or losses for each affiliated investment, rather than only for controlled companies.

In addition, the totals presented for Columns C and D should agree with the correlative amounts shown on the statement of operations. It may be necessary to include net realized and/or net unrealized gains or losses from investments in affiliates not held at the close of the period in order to reconcile the amounts presented in the schedule to the correlative amounts shown in the statement of operations.

Funds will also be required to categorize and present subtotals for investments in and advances to affiliates in a manner consistent with the instructions to Rule 12-12. Funds will also be required to indicate investments subject to option and to include the information required by Rule 12-13 for such investments.

- 1 Rule 6-02 states that the term “affiliate” means an affiliated person, as defined in Section 2(a)(3) of the Investment Company Act of 1940.
- 2 Rule 6-02 states that the term “control” has the meaning in Section 2(a)(9) of the Investment Company Act of 1940.



## Parting thoughts

Although the topics discussed in Part II do not result in any newly created schedules under Article 12, funds should not underestimate the impact of adopting these new requirements upon the compliance date. In particular, the new disclosure requirements for variable rate securities and for certain option contracts may result in significant reporting burdens to funds as a result of the information required to be presented.

Part III of this series will discuss the new requirements for open futures contracts, open forward foreign currency contracts, and open swap contracts. Part III will also discuss the amended requirements for other investments that are not addressed by other rule provisions within Article 12.





## Contact information

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