

## SEC Proposes Reporting Obligations for Advisers to Private Funds on New Form PF

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”) directed the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”) to require investment advisers to private funds to maintain records and file reports containing such information as the SEC and CFTC deem necessary to assist the Financial Stability Oversight Council (the “FSOC”) in assessing systemic risks. On January 25, 2011, the SEC and CFTC proposed new Rule 204(b)-1 under the *Investment Advisers Act of 1940* (the “Advisers Act”) to implement this provision of the Dodd-Frank Act. If adopted as proposed, Rule 204(b)-1 will require private fund advisers, including advisers to hedge funds, private equity funds and “liquidity funds” (i.e., private money market funds), to periodically file new Form PF with the SEC. The content and frequency of an adviser’s reporting obligations on Form PF would vary based on the types of private funds advised and the adviser’s assets under management (“AUM”). Generally, hedge funds and liquidity funds would be subject to more comprehensive reporting requirements than private equity funds, and certain “Large Private Fund Advisers” (generally advisers to funds with over \$1 billion in AUM) would be subject to the most comprehensive and frequent reporting requirements.

Comments on proposed Rule 204(b)-1 are due 60 days following the publication of the proposed rule in the Federal Register.

### Who is required to file on Form PF?

Under the proposed rule, any registered investment adviser that advises one or more private funds (i.e., funds relying on an exemption from registration as an investment company provided by Section 3(c)(1) or Section 3(c)(7) of the *Investment Company Act of 1940*) must file a Form PF with the SEC. A Commodity Pool Operator (a “CPO”) or a Commodity Trading Adviser (a “CTA”) that is also a registered adviser that advises one or more private funds would be required to file Form PF with respect to an advised commodity pool that is a private fund. If an adviser’s principal office and place of business is outside of the U.S., the adviser need not file on Form PF with respect to any private fund that during the last fiscal year was neither a United States person (as defined in Advisers Act Rule 203(m)-1, which includes any natural person that is resident in the U.S. nor offered to, or beneficially owned by, any United States person).

### When is an adviser required to file on Form PF?

All private fund advisers, other than Large Private Fund Advisers, would be required to file Form PF annually. Large Private Fund Advisers would be required to file Form PF quarterly. The SEC intends to implement a compliance date of December 15, 2011, at which time Large Private Fund Advisers would begin filing 15 days after the end of each quarter (i.e., such advisers would need to make their initial Form PF filing by January 15, 2012). All other private fund advisers would be required to file 90 days after the end of their first fiscal year occurring on or after the compliance date (i.e., all advisers with a December 31 fiscal year end that are not Large Private Fund Advisers would need to make their initial Form PF filing by March 31, 2012).

## How does the proposed rule define the different categories of private funds subject to Form PF?

The proposed rule defines a **hedge fund** as any private fund that:

1. Has a performance fee or allocation calculated by taking into account unrealized gains;
2. May borrow an amount in excess of one-half of its net asset value (“NAV”) (including any committed capital) or may have gross notional exposure in excess of twice its net asset value; or
3. May sell securities or other assets short.

The proposed rule defines a **liquidity fund** as any private fund that seeks to generate income by investing in a portfolio of short term obligations in order to maintain a stable NAV per unit or minimize principal volatility for investors.

The proposed rule defines a **private equity fund** as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course.

The three types of **Large Private Fund Advisers**, each of which would be subject to more comprehensive and frequent reporting requirements (described below), are defined in the proposed rule as:

1. Advisers managing hedge funds that collectively have at least \$1 billion in “regulatory assets under management” (as that term is defined in Form ADV and which includes gross invested assets plus uncalled committed capital) as of the close of business on any day during the quarterly reporting period;
2. Advisers managing a liquidity fund and having combined liquidity fund *and registered money market fund* regulatory assets under management of at least \$1 billion as of the close of business on any day during the reporting period; or
3. Advisers managing private equity funds that collectively have at least \$1 billion in regulatory assets under management as of the close of business on the last day of the quarterly reporting period for the required report.

For purposes of measuring regulatory assets under management to determine whether the \$1 billion threshold for Large Private Fund Advisers has been crossed, hedge fund and liquidity fund advisers would be required to make such calculation daily, and private equity funds would be required to make such calculation quarterly. Furthermore, for purposes of determining whether an adviser is a Large Private Fund Adviser, each adviser would have to aggregate:

1. Assets of managed accounts advised by the adviser that pursue substantially the same investment objective and strategy and invest in substantially the same positions as the private fund (“parallel managed accounts”); and
2. Private fund assets advised by any of the adviser’s “related persons” (which includes all persons controlling, controlled by or under common control with the adviser), if the reporting adviser advises private funds of the same type.

Advisers would be permitted, but not required, to report the private fund assets that it manages and the private fund assets that its related persons manage on a single Form PF. With respect to sub-advised funds,

only one adviser would be required to report information on Form PF with respect to that fund (generally, if an adviser completes information on Schedule D of Form ADV with respect to any private fund, the same adviser would be responsible for reporting on Form PF with respect to that fund).

## Information Required on Form PF

### Reporting Obligations of Advisers to All Private Funds

Rule 204(b)-1 would require all reporting advisers, including those that manage private funds other than those described above (e.g., real estate funds), to complete Sections 1a and 1b of Form PF. Section 1a would require identifying information of the adviser, as well as the adviser's gross and net AUM in total and the gross and net AUM attributable to certain types of private funds.

A separate Section 1b would be required for each private fund advised by a reporting adviser, including:

- The name of the fund;
- The fund's gross and net assets;
- The aggregate notional value of the fund's derivative positions;
- A breakdown of the fund's borrowing based on whether the creditor is a U.S. financial institution, foreign financial institution or non-financial institution;
- The identity of, and amount owed to, each creditor to which the fund owed 5% or more of the fund's NAV;
- The number of beneficial owners of the fund's equity interests;
- The percentage of equity held by the five largest equity holders; and
- Monthly and quarterly performance information.

### Reporting Obligations of Advisers to Hedge Funds

Section 1c would require the adviser to report, with respect to each hedge fund advised by the adviser:

- The hedge fund's investment strategies;
- The percentage of the fund's assets managed using computer-driven trading algorithms;
- The five largest trading counterparty exposures of the fund, and the five trading counterparties with the greatest exposure to the fund; and
- Trading and clearing practices (focusing on the extent to which the fund's trading activity is or is not subject to central clearing through trading on an exchange or otherwise).

Only Large Private Fund Advisers of hedge funds (i.e., an adviser with at least \$1 billion in hedge fund assets under management as of the close of business on any day during the reporting period) would be required to complete Section 2 of Form PF. Section 2a would require each such Large Private Fund Adviser to report the following aggregate information about the hedge funds it advises as a group:

- The market value of assets invested (on a short and long basis) in different types of securities and commodities;
- The duration of fixed income portfolio holdings (including asset-backed securities);

- The turnover rate of the adviser’s portfolios during the reporting period; and
- The geographic breakdown of investments held.

Section 2b would require any adviser to a hedge fund with a NAV of at least \$500 million (aggregating parallel funds, other funds in a master-feeder arrangement, and parallel separate accounts) (a “qualifying hedge fund”) to report additional information about any such fund it advises that is a qualifying hedge fund as of the close of business on any day during the reporting period. This information would be reported separately for each qualifying hedge fund the adviser manages. Section 2b would require, for each qualifying hedge fund, reporting of:

- The fund’s portfolio liquidity;
- Concentration of the fund’s positions;
- The fund’s collateral practices with significant counterparties;
- The identity of, and clearing relationships with, the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure;
- Certain hedge fund risk metrics (including any value at risk measure calculated regularly by the adviser during the reporting period);
- If regularly considered in the fund’s risk management, the impact on the fund’s portfolio from specific changes to certain identified market factors (including changes in equity prices, risk free interest rates, credit spreads, currency rates, commodity prices, option implied volatilities, ABS default rates and corporate bond default rates) broken down by long and short components of the fund’s portfolio;
- A monthly breakdown of the fund’s secured and unsecured borrowing;
- The fund’s derivatives exposures;
- The value of the collateral and letters of credit supporting the fund’s secured borrowing and derivatives exposure;
- Types of creditors;
- The term of any committed financing;
- Information about side pocket and gating arrangements; and
- A breakdown of outstanding investor lock-ups.

### Reporting Obligations of Advisers to Liquidity Funds

Only Large Private Fund Advisers to liquidity funds (i.e., those with at least \$1 billion under management (together with their related persons) in combined liquidity fund *and registered money market fund assets* as of the close of business on any day in the reporting period) would be required to complete Section 3. This section would require, for each liquidity fund, reporting of:

- Valuation and pricing methods used by the fund (amortized cost method or penny rounding method);
- Whether the fund is managed in compliance with Rule 2a-7 under the *Investment Company Act of 1940*;
- The fund’s NAV, NAV per share and market-based NAV per share;
- The fund’s weighted average maturity and weighted average life;
- The fund’s 7-day gross yield;

- The fund’s daily and weekly liquid assets;
- The amount of fund assets with a maturity greater than 397 days;
- The amount of fund assets invested in different types of instruments, broken down by the maturity of those instruments;
- Information about each open position that represents 5% or more of the fund’s NAV;
- Secured or unsecured borrowing (broken down by creditor type and maturity profile);
- Whether the fund has a committed liquidity facility;
- Concentration of the fund’s investor base;
- Gating and redemption policies;
- Investor liquidity; and
- A good faith estimate of the percentage of the fund purchased using securities lending collateral.

### Reporting Obligations of Advisers to Private Equity Funds

Only Large Private Fund Advisers to private equity funds (i.e., those managing at least \$1 billion in private equity fund assets as of the close of business on the last day of the reporting period) would be required to complete Section 4 of Form PF. This section would require, for each private equity fund, reporting of:

- The fund’s borrowings and guarantees;
- The outstanding balance of the fund’s borrowings and guarantees;
- The weighted average debt-to-equity ratio of “controlled portfolio companies”<sup>1</sup> in which the private equity fund invests, and the range of debt-to-equity ratios across controlled portfolio companies of the fund;
- A breakdown of the debt of controlled portfolio companies by maturity;
- The portion of controlled portfolio companies’ debt that is payment-in-kind or zero coupon;
- Whether the fund or any of its controlled portfolio companies experienced an event of default on any debt during the reporting period;
- The identity of the institutions providing bridge financing to controlled portfolio companies and the amount of that financing;
- The aggregate dollar amount of co-investments of the adviser’s related persons in any of the fund’s controlled portfolio companies;
- A breakdown of the fund’s investments by industry and by geography; and
- Information regarding any “financial industry portfolio company”<sup>2</sup> in which each private equity fund invests, including such financial industry portfolio company’s name, debt-to-equity ratio and percentage of the portfolio company beneficially owned by the fund.

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<sup>1</sup> A “controlled portfolio company” is defined as a portfolio company that is controlled by the private equity fund, either alone or together with the private equity fund’s related persons or other persons that are part of a club or consortium investing in the portfolio company. “Control” has the same meaning as used in Form ADV, and generally means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

<sup>2</sup> A “financial industry portfolio company” generally is defined as a nonbank financial company, as defined by section 102(a)(4) of the Dodd-Frank Act, bank or savings association, bank holding company or financial holding company, savings and loan holding company, credit union, or Farm Credit System institution.

## Use of Information

Information collected by the SEC on Form PF will also be made available to the CFTC (as it relates to commodity pools managed by CPOs and CTAs) and the FSOC. The SEC stated in the proposed rule release for Rule 204(b)-1 that while it intends to keep confidential the non-public information about private funds and their trading strategies elicited by Form PF, the SEC may use Form PF information in an enforcement action. The Dodd-Frank Act generally precludes the SEC and CFTC from being compelled to reveal this information, except in certain limited circumstances (at the request of Congress, pursuant to a U.S. federal court order or a request for information from another federal department or agency or self-regulatory organization requesting the information for purposes within the scope of its jurisdiction), and exempts the SEC and CFTC from being compelled under the *Freedom of Information Act* to disclose to the public any information collected through Form PF.

## Format for Reporting and Filing Fees

Form PF would need to be filed through an electronic system designated by the SEC for this purpose. Under the proposed rule, each fund to be listed on Form PF will require an identification number, which may be obtained by filing Form ADV (as a result, certain advisers may be required to file an amendment to Form ADV prior to the initial filing date solely for the purpose of obtaining private fund identification numbers for one or more funds). Form PF filers will be required to pay fees approved by the SEC to the operator of the Form PF filing system (these fees will likely be greater for Large Private Fund Advisers). Details concerning the filing system and fees will follow in a separate release from the SEC.

If you would like to learn more about the issues raised in this alert, please contact the lawyers listed below or your usual Ropes & Gray adviser.

[Joel A. Wattenbarger](#)  
[Jason E. Brown](#)  
[Michael G. Doherty](#)