



Legal Risk Management Tip February 2011

SEC PROPOSES SIGNIFICANT REPORTING REQUIREMENTS FOR INVESTMENT ADVISERS TO PRIVATE FUNDS

On January 26, 2011 the Securities and Exchange Commission (“SEC”) issued a release¹ proposing new rule 204(b)-1 under the Investment Advisers Act of 1940² to require registered investment advisers to report systemic risk information to the SEC if the adviser advises one or more private funds.³ The information collected would be made available to the Financial Stability Oversight Council (“FSOC”), as required by Section 404 of the Dodd-Frank Act, in order for the FSOC to monitor and assess the systemic risk that may be associated with the operation of private funds. The new disclosure document is known as Form PF, and the amount of information a private fund adviser would be required to report would vary based on both the size and type of funds it advises. Accordingly, the type and amount of information that would be required to be disclosed depends upon whether the adviser oversees hedge funds,⁴ liquidity funds,⁵ or private equity funds.⁶ “Large Private Fund Advisers” would be subject to quarterly filings, while all other private fund advisers would file Form PF only once a year and would report less information regarding the private funds they advise. The instructions to proposed Form PF define “Large Private Fund Advisers” as advisers to private funds with over \$1 billion in assets under management (“AUM”).

While Form PF is a very lengthy disclosure document that will require detailed responses,⁷ it would only be required to be filed by advisers to private funds registered or required to be registered with the SEC.⁸ Consequently, advisers relying on an exemption from registering with both of these regulators would not be subject to Form PF filing requirements. However, those required to file Form PF would continue to be required to file Form ADV.

¹ Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF, Advisers Act Release No. 3145, 76 Fed. Reg. 8068 (proposed Feb. 11, 2011) (to be codified at 17 C.F.R. pts. 4, 275, 279) available at <http://sec.gov/rules/proposed/2011/ia-3145fr.pdf> [hereinafter Release].

² 15 U.S.C. § 80b.

³ A “private fund” is defined in Section 202(a)(29) of the Advisers Act as an issuer that would be an investment company but for the exemptions found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. 15 U.S.C. § 80b-2(a)(29).

⁴ Proposed Form PF would define “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 (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (3) may sell securities or other assets short. Release, *supra* note 1, at 8075.

⁵ The proposed Form PF would define a liquidity fund as a private fund that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors. *Id.* As proposed, liquidity funds would thus resemble private money market funds.

⁶ The proposed Form PF would define 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.” *Id.*

⁷ As proposed, Form PF is 44 pages long.

⁸ Proposed Advisers Act Rule 204(b)-1. Commodity Pool Operators and Commodity Trading Advisers registered with the Commodity Futures Trading Commission (“CFTC”) would be required to file Form PF with respect to any advised commodity pool that is a “private fund.” Proposed Commodity Exchange Act Rule 4.27(d).

Section 1 of Form PF – Required by All Registered Advisers to Private Funds

Section 1 of Form PF would apply to all investment advisers required to file the form. Accordingly, all registered private fund advisers would be required to disclose information regarding each private fund they advise on Section 1 of Form PF regardless of AUM or type of funds advised. Under Section 1 of Form PF, advisers would include the following information:

- The private funds' total and net AUM, the amount of those assets that are attributable to certain types of private funds and the aggregate value of its derivative positions, if any;
- Information about the fund's borrowing practices, including a breakdown of the fund's lending 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 an amount equal to or greater than 5% of the fund's net asset value as of the reporting date;
- Basic information about how concentrated the fund's investor base is, such as the number of beneficial owners of the fund's equity and the percentage of the fund's equity held by the five largest equity holders;
- Monthly and quarterly performance information about each private fund advised; and
- Information only about the hedge funds managed by the adviser, such as the hedge fund's investment strategies, percentage of the fund's assets managed using computer-driven trading algorithms, significant trading counterparty exposures (including identity of counterparties), and trading and clearing practices.⁹

Section 2 of Form PF – Required by Large Hedge Fund Advisers

Form PF would require private fund advisers who had at least \$1 billion in hedge fund AUM as of the close of business on any day during the reporting period to complete Section 2. Under this section, the following information would be required:

- Exposure by asset class in different securities and commodities (*e.g.*, different types of equities, fixed income securities, derivatives, and structured products), the duration of fixed income holdings, geographical breakdown of investments, and turnover of the portfolio; and
- For each hedge fund advised by the adviser having AUM of at least \$500 million ("Qualifying Hedge Fund") Section 2 would also require information concerning:
 - Portfolio liquidity, position concentration, collateral practices, risk metrics, financing information, central clearing counterparties, borrowing and derivatives exposure, and other information on the Qualifying Hedge Fund's investors and financing arrangements.¹⁰

Section 3 of Form PF – Required by Large Liquidity Fund Advisers

Section 3 would be required to be completed by private fund advisers advising liquidity funds and registered money market funds having combined AUM of at least \$1 billion. Under this section the adviser would be required to disclose:

- Whether the liquidity fund uses the amortized cost method of valuation and/or the penny rounding method of pricing in computing its net asset value per share;
- For each month of the reporting period, the liquidity fund's net asset value and net asset value per share; and

⁹ Release, *supra* note 1, at 8079-80.

¹⁰ *Id.* at 8080-82.

- The amount of the liquidity fund's assets invested in different types of instruments, broken down by the maturity of those instruments, as well as information for each open position of the fund that represents 5 percent or more of the fund's net asset value and reporting of any secured or unsecured borrowing of the liquidity fund.¹¹

Section 4 of Form PF – Required by Large Private Equity Fund Advisers

Section 4 of Form PF would be required to be completed by private fund advisers managing at least \$1 billion in private equity fund assets as of the close of business on the last day of the reporting period. Under this section, such advisers would be required to provide information regarding:

- The outstanding balance of the fund's borrowings and guarantees, and the leverage of the portfolio companies in which the fund invests;
- A breakdown of the fund's investments by industry and by geography; and
- Additional information if the fund invests in any financial industry portfolio company, such as its name, its debt-to-equity ratio, and the percentage of the portfolio company beneficially owned by the fund.¹²

Confidentiality of Form PF

As outlined above, Form PF would include nonpublic information about private funds, their advisers and their trading strategies the disclosure of which could adversely affect the funds and their investors. In the proposing release, the SEC indicated that it does not intend to make Form PF information identifiable to any particular adviser or private fund, although it would make the information available to the FSOC, as required by the Dodd Frank Act. Additionally, the SEC may use Form PF in regulatory programs, examinations and investigations, and in investor protection efforts, such as enforcement actions and may share such information with foreign regulators to assist in its efforts to combat systemic risk.

Conclusion

While the information required to be included in Form PF is designed to assist the FSOC in identifying and managing risks that could affect the U.S. and global financial systems, the process of completing the form may help fund advisers and compliance personnel identify and manage risks affecting their respective firms.

The SEC is currently seeking public comment on proposed Form PF and proposed Rule 204(b)-1. To submit a comment, send an e-mail to rule-comments@sec.gov and include File Number S7-05-11 in the subject line.

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¹¹ *Id.* at 8082-83.

¹² *Id.* at 8083.