

# CLIENT UPDATE

## SEC UPDATES FORM PF GUIDANCE

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Most registered investment advisers who advise one or more private funds are required to file an annual update to Form PF, the systemic risk reporting form, within 120 days after the end of their fiscal year (April 30th for an adviser with a fiscal year end of December 31st).<sup>1</sup> With the 2014 Form PF filing deadline looming, the staff of the Division of Investment Management of the Securities and Exchange Commission ("SEC Staff") recently updated its Form PF FAQs.<sup>2</sup> The new FAQs are attached to this Client Alert; we have summarized some of the more significant updates below.

While most of the FAQs address fairly technical issues, one of the new FAQs revisits the perennial question of the circumstances under which a private equity fund is a hedge fund for purposes of Form PF. (The answer has not changed.)

Fund sponsors should review the new FAQs in connection with preparing their upcoming Form PF filings.

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<sup>1</sup> Certain large "hedge fund" advisers and large "liquidity fund" advisers are subject to more frequent reporting and shorter deadlines. Our November 16, 2011 Client Update, *SEC and CFTC Adopt Form PF for Registered Investment Advisers to Private Funds*, available at <http://www.debevoise.com/clientupdate20111116a>, describes the requirements relating to Form PF in greater detail than this Client Update.

<sup>2</sup> The SEC Staff's full Form PF FAQ is available here: <http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml>.

## PRIVATE EQUITY FUND DEFINITIONAL ISSUES

Form PF imposes different reporting requirements for each type of private fund (in particular, hedge funds, private equity funds and liquidity funds). The reporting requirements for hedge funds are particularly detailed.

For purposes of Form PF, a “hedge fund” is any private fund that, among other things, may borrow an amount in excess of one half of its net asset value (including any committed capital), have gross notional exposure in excess of twice its net asset value (including any committed capital) or sell securities or other assets short other than for the purpose of hedging currency exposure or managing duration.

Many private equity fund organizational documents allow a fund to employ leverage in amounts that would cause the fund to be a hedge fund. Similarly, the fund may be authorized to sell assets short. In many cases, the fund adviser has no intention to cause the fund to incur significant leverage or sell assets short. However, Form PF requires such funds to be treated as hedge funds.

FAQ D.1 restates that view. However, the FAQ states that, if a private fund is represented to investors as a private equity fund, real estate fund or venture capital fund, the fund’s adviser should include a note in Question 4 – the question that provides space for the adviser to explain any assumptions made in responding to any question in Form PF – indicating the category of private fund that the adviser believes better describes the fund and indicate why the reporting fund meets the definition of a hedge fund.

## FAQS OF INTEREST TO HEDGE FUND ADVISERS

FAQs 12.3 and 13.2 clarify that large fund advisers need not respond to certain questions in Section 2b of Form PF that duplicate information provided in response to questions in Section 1b. For example, Question 12 in Section 1b requires all private funds to provide information regarding the value of the reporting fund’s borrowings, including secured borrowings, unsecured borrowings and synthetic borrowings. Question 43 in Section 2b requires large hedge fund advisers to provide similar information. FAQ 12.3 clarifies that Question 12 need not be completed for any reporting fund that provides the information in response to Question 43. Similarly, a large hedge fund adviser need not respond to Question 13 of Section 1b (requesting certain information concerning derivatives positions) since such information would be included in response to Question 44 under Section 2b.

FAQ 26.5 provides additional guidance regarding proper reporting of long and short positions by large hedge fund advisers in response to Questions 26 and 30. The FAQ provides that the amount of cash borrowed via Reverse Repos should be considered the short value of Repos when reporting such exposures.<sup>3</sup>

Question 46(a) of Form PF requires large hedge fund advisers to provide, for each qualifying hedge fund, the aggregate dollar amount of borrowings by and cash financing available to the reporting fund (including all drawn and undrawn, committed and uncommitted, lines of credit as well as any term financing). Question 43 requires large hedge fund advisers to provide the value of the qualifying hedge fund's secured and unsecured borrowings. FAQ 46.2 clarifies that responses to Question 46(a) should include the borrowings reported in response to Question 43.<sup>4</sup>

## FAQS OF INTEREST TO ALL PRIVATE FUND ADVISERS

Form PF is designed to capture information concerning private funds and not parallel managed accounts that may engage in the same strategies. (However, assets managed in such parallel accounts are counted towards determining whether the manager has to file Form PF.) The SEC Staff provided guidance on how to report on parallel managed accounts when responding to questions related to a reporting fund in Section 1 of Form PF. While the staff expressed a preference that information regarding parallel managed accounts not be included (except in response to Question 11, which specifically asks about parallel managed accounts), FAQ E.2 permits a fund sponsor to include information concerning parallel managed accounts in responding to Form PF. If such information is included, that fact should be disclosed in response to Question 4.

Instruction 7 to Form PF states that a filer may disregard any private fund's equity investments in other private funds when reporting on Form PF. The SEC Staff, in FAQ F.5 recommends that an adviser indicate in Question 4 whether such investments are disregarded or included for purposes of reporting on Form PF.

Question 14 of Form PF requires the detailing of private fund assets and liabilities. FAQs 14.2 and 14.3 clarify a number of matters concerning how these items should be reported.

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<sup>3</sup> If a reporting fund sells a security with an agreement to repurchase such security at a later date at an agreed upon price, then such arrangement is defined as a "Reverse Repo" and is considered a borrowing, but if a reporting fund purchases a security together with an agreement to sell such security at a later date at an agreed price, then such arrangement is defined as a "Repo" and is not considered a borrowing.

<sup>4</sup> The response in Question 46(a) should be greater than or equal to the sum of the responses in Question 43 because Question 46(a) requests an amount that includes cash financing (e.g., lines of credit and term financing) available to the fund and the amount borrowed by the fund that is reported in Question 43.

FAQ 20.1 also clarifies how to respond to Question 20 of Form PF, which requires an adviser to indicate which investment strategies best describe the reporting fund's strategies. The FAQ clarifies that, for technical reasons, the total percentage of an adviser's net assets devoted to all of its strategies will likely exceed 100%.

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Please do not hesitate to contact us with any questions.

February 24, 2014

## NEW AND UPDATED FORM PF FAQs

**Q D.1: I advise a private fund that would be categorized as a private equity fund, except for the fact that the fund documents allow the fund to either employ large amounts of leverage or sell assets short. The fund does not in fact, nor does it intend to, incur leverage or short any assets. May I treat this private fund as a private equity fund instead of as a hedge fund for reporting purposes?**

A D.1: No. In adopting the Form, the Commission considered, but did not accept, commenters' arguments that the leverage and shorting characteristics in the definition of "hedge fund" should focus on actual or contemplated use, rather than potential use. See Investment Advisers Act Release No. 3308, text accompanying footnote 78. However, if the private fund you advise is represented to investors as a type of fund other than a hedge fund (i.e., as a private equity fund, real estate fund or venture capital fund), you may, and the staff recommends that you do, include a note in Question 4 indicating the category of private fund that you believe better describes the fund and indicate why the reporting fund meets the definition of a hedge fund. (Updated February 12, 2014)

**Q E.2: Instruction 5 states that, for purposes of reporting information in Sections 1b, 1c, 2b, 3 and 4, I am not required to report information regarding parallel managed accounts (except in Question 11). If I choose to report information regarding parallel managed accounts when responding to questions related to a reporting fund, how can I indicate to you this reporting method?**

Q E.2: We prefer that you not include information regarding parallel managed accounts (except in Question 11). If, however, you decide to include such information the staff recommends that, in Question 4, you indicate that you are reporting information regarding your parallel managed accounts when responding to questions related to a reporting fund other than Question 11. (Posted February 12, 2014)

**Q. F.5: Instruction 7 states that a filer may disregard any private fund's equity investments in other private funds when reporting on Form PF. Should I indicate to you whether I include or disregard the reporting fund's investment in other private funds when reporting on Form PF?**

A. F.5: We recommend that you indicate in Question 4 whether you disregard or include a reporting fund's investment in other private funds for purposes of reporting on Form PF. (Posted February 12, 2014)

**Q. 12.3: Question 12 asks for certain information regarding the value of the reporting fund's borrowings. I report similar information for qualifying hedge funds in Question 43. Should I also complete Question 12 for these qualifying hedge funds?**

A. 12.3: No. You are not required to complete Question 12 for any reporting fund with respect to which you are answering Question 43 in Section 2b. If you answer Question 43 with respect to a reporting fund, you should leave each part of Question 12 blank. (Posted February 12, 2014)

**Q. 13.2: Question 13(a) asks if the reporting fund has any outstanding derivatives positions. Question 13(b) instructs that, if you responded "yes" to Question 13(a), you provide the aggregate value of all derivatives positions of the reporting fund. I report similar information for qualifying hedge funds in Question 44. Should I also complete Question 13 for these qualifying hedge funds?**

A. 13.2: No. You are not required to complete Question 13 for any reporting fund with respect to which you are answering Question 44 in Section 2b. If you answer Question 44 with respect to a reporting fund, you should leave each part of Question 13 blank. (Posted February 12, 2014)

**Q. 14.2: In the cost-based column in Question 14, should I include those assets and liabilities that are not reported at fair value and therefore are not reflected in the fair value hierarchy, such as certain receivables and payables?**

A. 14.2: Yes. You should include assets and liabilities in the cost-based column that would be presented in a fund's financial statements using a measurement attribute other than fair value. See Investment Advisers Act Release No. 3308, footnote 210. As a result, the sum of the amounts entered in the assets row of Question 14 should approximate the reporting fund's gross assets reported in Question 8 at the time of reporting (except for funds with uncalled commitments included in their gross assets, in which case the sum of the values in the assets row of Question 14 will equal the gross assets minus the uncalled commitments amount because such amounts are not reflected as assets on a fund's balance sheet). Also, the sum of the amounts in the liabilities row of Question 14 should approximate the total liabilities reported on the fund's financial statements. If an asset or a liability is reported as representing fair value, but the fair value of the asset or liability is equal to its cost, then that asset or liability should still be categorized in the fair value hierarchy and should not be included in the cost-based column. (Updated February 12, 2014)

**Q. 14.3: Should I include cash and cash equivalents when providing a summary of a reporting fund's assets and liabilities in Question 14?**

A. 14.3: Yes, according to FAQ 14.2, the sum of the amounts entered in the assets row of Question 14 should generally approximate the reporting fund's gross assets reported in Question 8 at the time of reporting (except in the case of funds with uncalled commitments). Accordingly, cash should be included in the cost-based column and cash equivalents should be included in the applicable column in the fair value hierarchy or the cost-based column, depending on the nature of the cash equivalents. (Posted February 12, 2014)

**Q. 20.1: Question 20 requires that I indicate which investment strategies best describe the reporting fund's strategies. For each strategy, I am required to provide a good faith estimate of the percentage of the reporting fund's net asset value represented by that strategy. Instruction 15 states that, for Question 20, the numerator that I use to determine the percentage of net asset value must be measured on the same basis as gross asset value. In completing Question 20 for a reporting fund that has gross assets in excess of its net assets, should the total of my answers in the "% of NAV" column add up to more than 100%?**

A. 20.1: Yes, the responses to the "% of NAV" column should generally add up to more than 100%. You should note that the requirement in Instruction 15 regarding the use of gross assets also applies to Questions 21, 25, 28, 35 and 57. (Posted February 12, 2014)

**Q. 26.5: Should I report the value of a reporting fund's Reverse Repos as the Short Value (SV) in the "Repo" sub-asset class in Questions 26 and 30?**

A. 26.5: Yes, the amount of cash borrowed via Reverse Repos should be considered the short value (SV) of Repos when reporting the exposures in Questions 26 and 30. You should carefully review the definitions of "Repo" and "Reverse Repo" in the Glossary of Terms. If a reporting fund sells a security with an agreement to repurchase such security at a later date at an agreed upon price, then such arrangement is defined as a "Reverse Repo" and is considered a borrowing. See also FAQ 12.1. On the other hand, if a reporting fund purchases a security together with an agreement to sell such security at a later date at an agreed price, then such arrangement is defined as a "Repo" and is not considered a borrowing. (Posted February 12, 2014)

**Q. 46.2: Question 46(a) requires an adviser to provide, for each qualifying hedge fund, the aggregate dollar amount of borrowings by and cash financing available to the reporting fund (including all drawn and undrawn, committed and uncommitted, lines**

**of credit as well as any term financing). Question 43 requires that the qualifying hedge fund provide the value of the fund's secured and unsecured borrowings. Should my response to Question 46(a) include the borrowings I reported in Question 43?**

A. 46.2: Yes. Question 46(a) asks for current borrowings plus available cash financing. Generally, the response in Question 46(a) should be greater than or equal to the sum of the responses in Question 43 because Question 46(a) requests an amount that includes cash financing (e.g., lines of credit and term financing) available to the fund and the amount borrowed by the fund that is reported in Question 43. (Posted February 12, 2014)