Investment Management Regulatory Update

February 2022

Debevoise & Plimpton

FEBRUARY 24, 2022

SEC Proposes Significant New Reporting Requirements under Form PF

On January 26, 2022, the Securities and Exchange Commission (the "SEC") announced proposed amendments to Form PF,[1] the form adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") to provide information about registered investment advisers and the private funds they manage to the Financial Stability Oversight Counsel ("FSOC") to assist in its monitoring and assessment of systemic risk to the U.S. financial system.[2] In the Proposing Release, the SEC stated that the amendments are intended to continue with the original purpose of Form PF as a systemic risk monitoring tool, although the majority of the occurrences and transactions that would be required to be reported under the proposed amendments do not appear to raise systemic risks. These items, however, have been consistently noted by the SEC and its staff in recent speeches and risk alerts as private fund conflicts of interests that are of particular interest to the SEC, which suggests that the SEC and its staff may intend to treat Form PF as a compliance monitoring tool as much as a systemic risk tool.

The proposed amendments to Form PF fall into two broad categories with respect to private fund sponsors: (1) the requirement for current (one-day) reporting of certain key events and (2) additional reporting requirements for a broader group of private fund advisers. Below, we discuss the proposed additional reporting requirements applicable to private funds and their advisers.[3] Most, if not all, of the proposed additional and current reporting requirements are likely to be burdensome to private fund advisers without any apparent commensurate investor protection benefits, and do not appear to be sufficiently related to advancing the core systemic risk monitoring purpose of the Dodd-Frank Act for which Form PF was originally adopted.

1. Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, SEC Release No. IA-5950; File No. S7-01-22 (Jan. 26, 2022), https://www.sec.gov/rules/proposed/2022/ia-5950.pdf (the "Proposing Release").
2. *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, SEC Release No. IA-3308; File No. S7-05-11 (Oct. 31, 2011), 76 Fed. Reg. 71128 (Nov. 16, 2011), https://www.sec.gov/rules/final/2011/ia-3308.pdf ("Form PF Adopting Release").
3. The Proposing Release also proposes amended requirements for large liquidity fund advisers, which are not addressed in this summary.

Current Reporting within One Business Day for Private Fund Advisers.

The Proposing Release indicates a number of key events that the SEC states could aid in establishing a more refined and current understanding of trends and emergent market volatility in the private fund industry that is not possible under the existing reporting regime. The SEC additionally justifies the new key event triggers by reference to the utility of the information in administering its regulatory examination and investigation programs, which appears fundamentally inconsistent with the primary purpose of Form PF.[4]

Current Reporting for Private Equity Fund Advisers:

Proposed new section 6 of Form PF (for private equity fund advisers) would require reports to be filed with the SEC within one (1) business day of the reportable events discussed below. There is no precedent for this type or timing of reporting for private fund advisers.

- *Completion of Adviser-Led Secondary Transactions*. A private fund adviser would be required to report the completion date and a brief description upon the completion of an adviser-led secondary transaction (*i.e.*, that is "initiated" by the adviser or a related person). The Proposing Release defines an adviser-led secondary transaction as one that offers private fund investors the choice to (a) sell all or a portion of their interests in the private fund or (b) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

  The SEC's primary justification for adviser-led secondary transactions being reportable is the increasingly common and conflicted nature of such transactions, and the potential that an increase in adviser-led secondary transactions can signal a declining market. The Proposing Release does not, however, address that adviser-led secondary transactions are commonly welcomed by fund investors, given the economic benefits available to investors. The SEC also failed to acknowledge the strategic, business judgments that typically drive the commercial decision to engage in an adviser-led secondary transaction, which are unrelated to systemic risk or market turmoil. The Proposing Release also ignores the conflict mitigation steps that private fund advisers take when considering such transactions, including thoughtful disclosure and, in some cases, investor consent, to demonstrate compliance with their fiduciary obligations.

- *Implementation of General Partner Clawback*. An adviser would be required to report the effective date of a general partner clawback and the reason for the clawback upon the implementation of such a clawback.The Proposing Release defines a general partner clawback as any obligation of the general partner or related persons (or their respective owners or interest holders) to restore or otherwise return performance-based compensation to the fund pursuant to its governing agreements.

  The SEC's primary justification for reporting general partner clawbacks is that the implementation of general partner clawbacks by many funds is unusual and would indicate the early stages of a distressed credit

4. *See, e.g.*, Commissioner Hester M. Peirce, Statement on Proposed Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers (Jan. 26, 2022), https://www.sec.gov/news/statement/peirce-form-pf-20220122.

environment or cycle. The Proposing Release does not, however, address the variable, and often significantly negotiated (by fund investors) commercial arrangement regarding the structure of general partner clawbacks in fund-governing agreements.In addition, general partner clawbacks are typically done at the end of the term of a fund on a cumulative retrospective basis, which means that the implementation of a general partner clawback could be due to significant losses well before the clawback occurs.

- *Implementation of Limited Partner Clawback.* An adviser would be required to report the effective date of a limited partner clawback and the reason for the clawback upon the implementation of such a clawback (or series of clawbacks) in excess of 10% of a fund's aggregate capital commitments.The Proposing Release defines a limited partner clawback as any obligation of a fund's investors to return all or any portion of a distribution made by the fund to satisfy a liability, obligation or expense of the fund pursuant to the fund's governing agreements.

  The SEC's primary justification for reporting limited partner clawbacks is that the implementation of limited partner clawbacks above the specified threshold would tend to indicate that a fund is under stress or anticipates being under stress.The Proposing Release does not, however, discuss that the need to implement limited partner clawbacks is closely linked to other commercial features of a fund such as the ability of the fund to draw down capital when needed (particularly in the later stages of a fund), take reserves or otherwise withhold distributions for anticipated liabilities, and that the implementation of limited partner clawbacks is often a highly fund-specific, commercial decision that does not necessarily stem from broader market conditions.

- *Receipt of Notification of General Partner Removal, Investment Period Termination or Fund Termination by Fund Investors.* An adviser would be required to report the effective date of, and a brief description of the following, upon any notification received by a fund that its investors have, pursuant to the fund's governing documents, (a) removed the adviser or an affiliate as the general partner or similar control person of a fund, (b) elected to terminate the fund's investment period or (c) elected to terminate the fund.A current report would not be required in the case of a termination of the investment period or the fund by an adviser (including with the approval of the requisite fund investors) or in the ordinary course pursuant to the fund's governing documents.

  The SEC primarily justifies this reportable event trigger as an indication that fund liquidation could occur earlier than anticipated, which could impact markets.The Proposing Release does not, however, acknowledge that the slate of available fund investor remedies can vary significantly across funds (and the range of procedures associated with their implementation, making identification of the trigger point for this reportable event unclear), as can the various fund- or adviser-specific reasons unrelated to broader market conditions that could form the basis for the exercise of these remedies.

Current Reporting for Large Hedge Fund Advisers:

Proposed new section 5 of Form PF (for hedge fund advisers) would require reports to be filed with the SEC within **one (1) business day** of the reportable events discussed below.As noted above, there is no precedent for this type or timing of reporting for private fund advisers.

Several of the proposed reportable events are triggered based on changes relative to a hedge fund's "most recent net asset value," which is defined as the net asset value of the fund as of the data reporting date at the end of the most recent reporting period, which the SEC notes would typically be the most recent update to a fund's regular quarterly or annual Form PF filing. The SEC acknowledges in the Proposing Release the over-inclusive and under-inclusive nature of using this definition of most recent net asset value.In addition, these reporting events do not take into account varying valuation practices across advisers and the complexities around nonmarketable, illiquid and other difficult-to-value positions, which can comprise significant portions of hedge fund portfolios.

- *Extraordinary Investment Losses*. A hedge fund adviser would be required to describe losses (including the dates over which the relevant loss occurred and the dollar amount of the loss) that are equal to or greater than 20% of a fund's most recent net asset value over a rolling 10-business-day period. Continuing extraordinary investment losses would not trigger another reporting requirement until a second rolling 10-business-day period beginning no earlier than the end date of a prior reportable extraordinary loss period. The SEC asserts in the Proposing Release that such losses could potentially signal precipitous liquidation or broader market instability that could have other downstream consequences.
- *Certain Margin Events*. The proposed amendments would require hedge fund advisers to report: (a) the dates over which a significant increase in margin, collateral or equivalent requirements occurs, the cumulative dollar amount of the increase and the identity of the counterparties requiring the increase. For this purpose, significant increases would include a cumulative increase of margin of more than 20% of the fund's most recent net asset value over a rolling 10-business-day period; (b) with respect to each separate counterparty, the date the adviser determines or is notified that a reporting fund is in margin default or will be unable to meet a margin call with respect to a counterparty, the dollar amount of the margin, collateral or equivalent involved, the identity of the counterparty and a checkbox description of the circumstances of such default; and (c) the date and dollar amount of a margin default by a counterparty and the identity of the counterparty, if the amount involved is greater than 5% of the most recent net asset value of the reporting fund.
- *Material Changes in Prime Broker Relationships*. A hedge fund adviser would be required to report material changes (*e.g.*, material trading limits or investment restrictions, including requests to reduce or unwind positions) to the fund's ability to trade or a termination of the prime brokerage relationship for default or breach of the prime brokerage agreement (by either party), including the date of the material change, the identity of the prime broker involved and a checkbox description of the circumstances of the material change. The Proposing Release does not provide significant guidance as to what a "material" change would entail.
- *Changes in Unencumbered Cash*. Any unencumbered cash declines by more than 20% of the fund's most recent net asset value over a rolling 10 business day period would be required to be reported.The current report would include the last day of the rolling period and the dollar amount of unencumbered cash on the last day of such period, as well as checkbox descriptions of the facts and circumstances around such decline.This event does not appear to recognize, for example, seasonal, event-driven, dislocation or other opportunistic fund strategies.

- *Operations Events.* A hedge fund adviser would be required to report when either the adviser or fund experiences a significant disruption or degradation of the fund's key operations, which may also include events occurring at service providers."Key operations" means operations necessary for the investment, trading, valuation, reporting and risk management of the reporting fund, as well as the operation of the reporting fund in accordance with federal securities laws and regulations; "significant disruption or degradation" means a 20% disruption or degradation of normal volume or capacity.Advisers would be required to report the date of the operations event and the date on which such event was discovered, as well as provide checkbox descriptions regarding the circumstances of the event and the impact of the event on operations of the fund.The Proposing Release does not provide significant guidance around what constitutes reportable operations events.
- *Certain Events Associated with Redemptions.* The proposed amendments would require hedge fund advisers to report:(a) the date on which net redemption requests exceed 50% of the most recent net asset value, the net value of redemptions paid since the last reported fiscal quarter on Form PF, the percentage of the fund's net asset value the redemption requests represent and whether the adviser has notified the investors that the reporting fund will liquidate; and (b) the date the fund was unable to pay redemption requests or suspended redemptions (if for more than five consecutive business days), the percentage of redemptions requested and not yet paid and whether the adviser has notified the investors that the reporting fund will liquidate.The Proposing Release, however, does not appear to acknowledge the range of tools available to hedge fund advisers to manage significant redemption requests (including redemption gates, lockups, suspension rights and clearly disclosed payment mechanisms that would not require undesirable early liquidation of assets).

No Updating Requirement; Operational Issues:

The proposed amendments do not include a requirement to update Form PF following the occurrence of any of these reporting events, either on an ad hoc basis or in connection with the regular quarterly or annual filings, although the SEC would continue to permit voluntary post hoc updates.The Proposing Release also does not indicate any plans to change the confidential treatment of Form PF current reporting.

In general, the relationship between near instantaneous, current reporting of the specified key events and the monitoring of systemic risk appears attenuated, and the specified reporting events selected by the SEC are often driven by commercial judgments rather than being indicative of, or due to, broader market decline. We encourage private fund advisers to provide comments to the SEC regarding the significant operational and administrative burdens that the proposed amendments present.Dedicating resources to complete a current report on Form PF within one business day following a reportable key event is likely to detract materially from a private fund adviser's ability to communicate with fund investors, and manage and navigate their funds and investors through evolving commercial situations, including those that can be value-enhancing and for the benefit of fund investors.

Additional Reporting from More Private Equity Fund Advisers.

Form PF currently requires reporting by "large private equity advisers" that are defined with reference to a $2 billion assets under management threshold.The proposed

amendments would (a) lower this threshold to $1.5 billion in assets under management and (b) require new reporting in regular quarterly and annual reports.

The Proposing Release indicates that the current $2 billion reporting threshold adopted in 2011 with the original release of Form PF has captured fewer private equity fund advisers over time (67% now, compared to 75% in 2011), and proposes the lowering of the reporting threshold to $1.5 billion in order to capture 75% of private equity fund advisers again.It is unclear why the SEC chose 75% as a meaningful threshold for purposes of FSOC's systemic risk-monitoring function, and the Proposing Release does not make clear why (or whether) the significant proportion of private equity fund advisers that are reporting under the current $2 billion threshold has become insufficient to monitor systemic risk.

Annual reporting on Form PF for private equity fund advisers would be expanded to include new questions covering the following topics, with certain notable requested disclosure items detailed below:

Fund-Level Reporting:

- *Fund strategies and geographical breakdown of investments.* Includes good-faith estimates of the percentage of deployed capital represented by each strategy and identification of all countries (by ISO country code) to which a fund has exposure of at least 10% of net asset value.
- *Investments by funds managed by the same adviser in different levels of a portfolio company's capital structure.* Requires disclosure of the name of the portfolio company and a description of the class, series or type of securities held by each related fund.
- *Fund-level borrowings.* Includes whether a fund borrows or has the ability to borrow and information on each borrowing, amounts available and average amounts borrowed over the reporting period.
- *Events of default.* Includes more granular reporting about the nature and cause of reported events of default (*e.g.*, payment defaults of the fund or a CPC or failure to uphold terms under a borrowing agreement).

Portfolio Company-Level Reporting:

- *Portfolio company restructurings or recapitalizations.* Requires disclosure of the name of the portfolio company and the effective date of the restructuring, if following the fund's investment period.There is no definition of restructuring or recapitalization in the Proposing Release and it is unclear whether the reporting of private portfolio company information is within the scope and purpose of the Dodd-Frank Act.
- *Portfolio company financings.* Includes financings or extensions of credit by an adviser or its related persons to a portfolio company in which a fund advised by it invests, and information on the value of such financing.
- *Information regarding controlled portfolio companies ("CPCs").* Includes the percentage of aggregate borrowings of a reporting fund's CPCs at a floating rather than fixed rate, the number of CPCs a fund owns and the identity of counterparty institutions providing bridge financing to CPCs (and the amounts of such financings).

The comment period for the proposed amendments will close on March 21, 2022. Thus far, reactions to the proposed amendments to Form PF have been strong given the

unprecedented scope and application of the proposed amendments—particularly the one-day reporting requirement.These proposed amendments represent the first step in the SEC's agenda to bring more regulation (and regulatory scrutiny) to private fund advisers, and we note that the SEC, in the weeks following the announcement of the Proposing Release, proposed sweeping disclosure and conduct regulations applicable to private fund advisers and their funds and new cybersecurity compliance rules applicable to registered advisers. As indicated by the SEC's fall 2021 regulatory agenda,[5] additional rule proposals and interpretations are expected throughout the remainder of this year.

Please do not hesitate to contact us with any questions.

5. *See* Securities and Exchange Commission, Agency Rule List – Fall 2021, here and here.

Authors

Marc Ponchione
Partner, Washington, D.C.
mponchione@debevoise.com
+1 202 383 8290

Marc Ponchione, a partner in the firm's Investment Management Group, focuses on advising financial services firms on various regulatory, compliance and transactional issues arising in the asset management industry. Mr. Ponchione is based in the firm's Washington, D.C. office.

Mr. Ponchione represents asset managers, funds, sponsors and issuers of financial products on a broad range of regulatory and transactional issues inside and outside the United States. He regularly advises clients on issues under the federal securities laws, including the Investment Company Act of 1940 and the Investment Advisers Act of 1940 as well as various other regulations affecting investment managers, funds and financial product sponsors.

From 2001 to 2006, he served as senior counsel at the Securities and Exchange Commission (Division of Investment Management). Mr. Ponchione serves on the American Bar Association Subcommittee on Hedge Funds, the American Bar Association Subcommittee on Investment Companies and Investment Advisers and the New York City Bar Committee on Investment Management Regulation. He frequently writes on investment management best practices and issues for various legal and business publications, and is an adjunct professor at Georgetown University Law Center.

Mr. Ponchione received his B.A. from Marietta College in 1996 and his J.D. from Duquesne University in 1999. He serves on the Board of Trustees at Marietta College.

Sheena Paul
Counsel, Washington, D.C.
spaul@debevoise.com
+1 202 383 8178

Sheena Paul is a counsel in the Investment Management Group's U.S. regulatory practice, based in the firm's Washington, D.C. office. Ms. Paul focuses her practice on providing regulatory advice to investment managers, with a particular focus on private equity clients. She works closely with the firm's other practices on regulatory advice related to domestic and cross-border corporate and capital markets transactions, and enforcement matters.

Ms. Paul has extensive experience advising asset managers and institutional investors on a broad range of U.S. regulatory matters, regularly advising on issues arising under the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Securities Act of 1933. She has also provided U.S. regulatory support for transactions and played an active role in private fund formations.

Ms. Paul previously worked in the asset management group of another international law firm.

She received her B.A. from Macalester College in 2007 and her J.D. from Georgetown University Law Center in 2012.

Nathan K. Noh
Associate, New York
nknoh@debevoise.com
+1 212 909 6953

Nathan K. Noh is a corporate associate and a member of the firm's Investment Management Group. His practice focuses on seed capital, anchor, staking, joint venture and other bespoke strategic investment management transactions. Mr. Noh also routinely advises on the formation, management and operation of private investment funds, accounts (including separately managed accounts) and co-investment vehicles, including hedge, private equity, credit and hybrid products, as well as upper-tier arrangements and regulatory compliance matters. Mr. Noh's recent experience includes representing Apollo Global Management, The Blackstone Group, BMO Financial, Investcorp, KKR, Morgan Stanley and PSP Investments.

Mr. Noh joined the firm in 2019. He received a J.D. from New York University School of Law in 2016, where he served as the senior articles editor for the N.Y.U. Journal of Legislation & Public Policy. He received a B.S. with honors from the University of California, Berkeley in 2013.