

## **REGISTERED ADVISERS TO PRIVATE FUNDS HIT WITH NEW RISK REPORTING ON FORM PF**

February 3, 2011

To Our Clients and Friends:

The impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) on private fund advisers continues to unfold. In addition to rescinding the exemption from registration under the Investment Advisers Act of 1940 (the “Advisers Act”) that many private fund advisers rely upon, Title IV of the Dodd-Frank Act also authorizes the Securities and Exchange Commission (the “SEC”) to require registered investment advisers that manage private funds (“Private Fund RIAs”), including commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) that are also registered investment advisers, to file reports for, among other reasons, the purpose of assessing systemic risk. At the end of January, the SEC and the Commodity Futures Trading Commission (the “CFTC”) jointly proposed rules to mandate that Private Fund RIAs file a new Form PF with the SEC.<sup>1</sup>

Form PF is principally designed to assist the Financial Stability Oversight Council (“FSOC”) in its assessment of systemic risk in the U.S. financial system posed by investment funds that are exempt from registration under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (“Private Funds”). The development of Form PF was based in part on international efforts to increase systemic risk reporting for private funds. The proposed Form PF reflects consultations with the International Organization of Securities Commissions, the U.K. Financial Services Authority and the Hong Kong Securities and Futures Commission.

The proposed form is interesting from a number of perspectives. First, there are different reporting requirements depending on the type of Private Fund—most importantly, the SEC and CFTC have taken pains to distinguish hedge funds, private equity funds and liquidity funds (unregulated money-market-type funds) from each other and from other Private Funds. Second, the frequency of filing and the level of detail required also depends on the Private Fund RIA’s assets under management (“AUM”) relating to certain types of Private Funds. Third, Form PF is only required to be filed by registered investment advisers. Advisers to private funds that are exempt from SEC registration because their sole clients are venture capital funds or because their sole clients are private funds and they have less than \$150 million in AUM “in the United States”—so-called “exempt reporting advisers”—

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<sup>1</sup> *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, SEC Release No. IA-3145 (Jan. 26, 2011).*

are required to file Part 1A of Form ADV.<sup>2</sup> The SEC has requested comment as to whether these “exempt reporting advisers” should also be required to file a Form PF.

### **CLASSIFICATION OF PRIVATE FUNDS IN FORM PF**

Due to the different reporting requirements for each type of Private Fund (in particular, hedge funds, private equity funds and liquidity funds), the definitions underlying the classification are important. For purposes of Form PF, a “Hedge Fund” is any Private Fund that:

- has a performance fee or allocation calculated by taking into account unrealized gains (*i.e.*, a performance fee using mark-to-market values instead of realized gains);
- 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
- may sell securities or other assets short.

A “Private Equity Fund” is mostly defined by what it is not (*i.e.*, it does not meet the definition of a Hedge Fund, Real Estate Fund, Securitized Asset Fund, Liquidity Fund or Venture Capital Fund). The result is that a Private Equity Fund is a Private Fund that:

- if it has a performance fee, such performance fee or allocation is calculated based upon realized gains (see the definition of Hedge Fund);
- may not borrow more than one-half of its net asset value (including any committed capital) and may not have gross notional exposure more than twice its net asset value (including any committed capital) (see the definition of Hedge Fund);
- may not engage in short selling of any securities or assets (see the definition of Hedge Fund);
- does not invest primarily in real estate and real estate-related assets (see the definition of Real Estate Fund);<sup>3</sup>

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<sup>2</sup> *Client Update: SEC Proposes Rules to Implement the Dodd-Frank Act's Advisers Act Provisions (Dec. 22, 2010) available at <http://www.debevoise.com/newsevents/pubs/publications/detail.aspx?id=046b5b00-2e17-4c3a-89b7-75fc4b9793ec>.*

- does not issue asset-backed securities and has no investors who are primarily debt-holders (see the definition of Securitized Asset Fund);<sup>4</sup>
- does not seek 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 (see the definition of Liquidity Fund);<sup>5</sup>
- does not meet the definition of “venture capital fund” in the recently proposed Rule 203(l)-1 of the Advisers Act; and
- does not provide investors with redemption rights in the ordinary course.

One implication of these definitions is that a Private Fund that would normally be viewed as a “private equity fund” or a “real estate fund” in the market would be considered a Hedge Fund for purposes of Form PF if the Private Fund may engage in any short sale or may borrow in excess of the threshold noted above. The breadth of the definition of “Hedge Fund” will likely receive substantial comment.

#### **FORM PF: LARGE VERSUS SMALL PRIVATE FUND ADVISERS**

Certain Private Fund RIAs will be required to file Form PF quarterly and to provide more disclosure. These enhanced reporting requirements would apply if a Private Fund RIA has (i) at least \$1 billion in AUM attributable to Hedge Funds (a “Large Hedge Fund Adviser”); (ii) at least \$1 billion in AUM attributable to Private Equity Funds (a “Large Private Equity Fund Adviser”); or (iii) at least \$1 billion in AUM attributable to Liquidity Funds (a “Large Liquidity Fund Adviser”). The Private Fund RIA will need to aggregate assets across any parallel managed accounts, parallel funds, funds that are part of the same master-feeder arrangement, and private funds managed by the Private Fund RIA’s related persons, so long as those accounts and funds are in the same category of Private Fund. Since the enhanced requirements are only for Large Hedge Fund Advisers, Large Private Equity Advisers and Large Liquidity Fund Advisers (collectively, “Large Private Fund Advisers”), an adviser with more than \$1 billion in AUM solely relating to Real Estate Funds, for example, would not be

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<sup>3</sup> A “Real Estate Fund” is a Private Fund that: (i) is not a Hedge Fund; (ii) does not provide investors with redemption rights in the ordinary course; and (iii) invests primarily in real estate and real estate assets.

<sup>4</sup> A “Securitized Asset Fund” is any Private Fund that is not a Hedge Fund and that issues asset-backed securities and whose investors are primarily debt-holders.

<sup>5</sup> A “Liquidity Fund” is any 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.

considered a Large Private Fund Adviser and would not be subject to the enhanced reporting requirements.

The Proposed Rules require a Private Fund RIA to determine whether it is a Large Private Fund Adviser by calculating its AUM attributable to Hedge Funds and Liquidity Funds on a monthly basis and its AUM attributable to Private Equity Funds on a quarterly basis.

All Large Private Fund Advisers are required to file a Form PF within 15 calendar days after each calendar quarter. Private Fund RIAs that are not Large Private Fund Advisers are only required to file an updated Form PF annually at the same time as the annual amendment to their Form ADV (currently, no later than 90 days after the end of the RIA's fiscal year).

### **FORM PF CONTENT**

Form PF is daunting in length. It has five separate sections. Different kinds and sizes of Private Fund RIAs will be required to fill out different sections.

The SEC and CFTC state in the proposing release that the information provided on Form PF will be kept confidential among the SEC, the CFTC and FSOC and may not be disclosed except to Congress upon agreement of confidentiality, to comply with a request by any other U.S. federal government department or agency or any self-regulatory organization within its scope of jurisdiction, or by order of a U.S. court in an action brought by the United States or the SEC. Notably, the SEC also makes clear that the information can be used in enforcement proceedings.

Form PF should also be viewed in conjunction with the recently proposed amendments to Form ADV (the registration statement for investment advisers) that significantly increase the information required to be reported by Private Fund RIAs.<sup>6</sup> The purposes of the two forms are ostensibly different. Form PF is focused principally on systemic risk issues, while the proposed Form ADV disclosure for Private Fund advisers (which is publicly available) largely focuses on investor protection issues, as well as providing the SEC with information for its examination program.

We have prepared the attached chart as a guide to the reporting requirements for different types of Private Fund RIAs. Noteworthy among the requirements are the following:

- Section 1 requires that monthly and quarterly performance data be provided for all Private Funds.

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<sup>6</sup> *Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Release No. IA-3110 (Nov. 19, 2010).*

- The form requires advisers to Hedge Funds to provide information concerning investment strategies, counterparty exposures, and trading and clearing practices. There is also extensive disclosure for Large Hedge Fund Advisers, in particular, with respect to Qualifying Hedge Funds (those that have a net asset value of at least \$500 million). These advisers would be required to provide more detail concerning liquidity, concentration, collateral practices, risk metrics and financing relating to these Qualifying Hedge Funds.
- Large Private Equity Fund Advisers are required to provide information on the borrowings of the fund, indebtedness of certain portfolio companies and investments by the fund (by industry and geography).

### **APPLICATION TO NON-U.S. ADVISERS**

The Proposed Rules would apply to any Private Fund RIA, even those that have their principal office and place of business outside of the United States. However, such advisers do not need to report any information with respect to a Private Fund that is neither (i) a U.S. person nor (ii) offered to or beneficially owned by a U.S. person. The term “U.S. person” has the same definition as in the SEC’s proposed Rule 203(m)-1 and is similar but not identical to the definition in Regulation S under the Securities Act of 1933.

### **CONCLUSION**

Comments on the Proposed Rules are due in early April. The SEC expects that Form PF will be required to be filed with respect to 2011, and that Large Private Fund Advisers will be required to make their first filing on January 15, 2012, with other Private Fund RIAs filing their first annual report with their annual Form ADV update in 2012. There will be a filing fee associated with Form PF in order to finance the development and maintenance of a new filing system that is being developed for the Form. Thus, Private Fund RIAs will bear not only the costs of preparing the form, but filing it as well.

The CFTC also released proposed rules amending Part 4 of the Rules under the Commodity Exchange Act. They propose, among other things, to add new Rule 4.27, which would require CPOs and CTAs that are registered with the CFTC but are not registered as RIAs with the SEC to file Forms CPO-PQR and CTA-PR with the CFTC containing essentially the same information as is required for registered investment advisers under the Proposed Rules.

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Please call us if you have any questions.

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## **SUMMARY OF FORM PF REPORTING REQUIREMENTS FOR HEDGE FUND AND PRIVATE EQUITY FUND MANAGERS<sup>1</sup>**

### **All Private Fund Advisers (Sections 1a & 1b)**

- The assets under management relating to each category of Private Funds (hedge, liquidity, private equity, real estate, securitized asset, venture capital and other) and to non-Private Fund clients;
- The gross and net asset value of each Private Fund;
- The amount of borrowings of each Private Fund (and source by category) and the identity of each creditor with respect to borrowings of at least 5% of the Private Fund's net asset value;
- Investor concentration information; and
- Fund performance data on a monthly and quarterly basis.

### **All Hedge Fund Advisers (Section 1c)**

- The fund's category of investment strategy;
- Percentage of the fund's net asset value managed using computer-driven trading algorithms to select investments;
- Significant trading counterparty exposures (including the identity of the five trading counterparties to which the fund has the greatest net counterparty credit exposure and that have the greatest net counterparty credit exposure to the fund); and
- Trading and clearing practices (regulated exchanges versus over-the-counter, central clearing counterparty versus bilateral).

### **All Large Hedge Fund Advisers (Sections 2a & 2b)**

- 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 (to indicate the assets' interest rate sensitivity);
- The turnover rate of the RIA's aggregate portfolios during the reporting period (to provide an indication of the RIA's frequency of trading); and
- A geographic breakdown of investments held by the Hedge Funds it advises.

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<sup>1</sup> *A summary of the enhanced reporting requirements for liquidity funds has not been included.*

- With respect to Qualifying Hedge Funds (greater than \$500 million),
  - Portfolio liquidity (including the percentage of the fund's portfolio capable of being liquidated within different time periods);
  - Concentration of positions (including positions that represent 5% or more of the fund's net asset value);
  - Collateral practices with significant counterparties (including the identity of, and clearing relationships with, three central clearing counterparties to which the fund has the greatest net counterparty credit exposure);
  - Certain Hedge Fund risk metrics, financing information and investor information (including the impact on the fund's portfolio of specified changes to certain identified market factors, such as risk-free interest rates, credit spreads, currency rates, etc.);
  - Certain financing information (including a monthly breakdown of its secured and unsecured borrowing and derivatives credit exposures, the value of the collateral and letters of credit supporting the secured borrowing and derivatives exposures, the types of creditors, and a breakdown of the terms of the fund's committed financing); and
  - Investor composition and liquidity (including questions about the fund's side pocket and gating arrangements and a breakdown of the percentage of the fund's net asset value that is locked in for different periods of time).

**Large Private Equity Fund Advisers (Section 4)**

- Borrowings of the fund (including the total outstanding balance of all loans and borrowing facilities);
- Indebtedness of controlled portfolio companies (including the weighted average, high and low of their debt-to-equity ratios, and a breakdown of the maturities);
- Bridge loans by any person to controlled portfolio companies (including the identity and amount of any creditor or counterparty);
- Investments by the fund in financial industry portfolio companies; and
- Breakdowns of the fund's investments by industry and geography.