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

On October 26, 2011, the Securities and Exchange Commission (the "SEC") adopted Rule 204(b)-1 under the *Investment Advisers Act of 1940* (the "Advisers Act") requiring periodic reporting by private fund managers on new Form PF. The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") directed 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. Advisers Act Rule 204(b)-1 implements this Dodd-Frank Act provision by requiring registered investment advisers that advise private funds, including advisers to hedge funds, private equity funds and "liquidity funds" (i.e., private money market funds), to periodically file Form PF with the SEC.

The content and frequency of an adviser's reporting obligations on Form PF vary based on the types of private funds advised and the adviser's assets under management ("AUM"). Generally, advisers to hedge funds and liquidity funds are subject to more comprehensive reporting requirements than private equity funds. Additionally, advisers to liquidity funds with over $1 billion in AUM, advisers to hedge funds with over $1.5 billion in AUM, and advisers to private equity funds with over $2 billion AUM (each, a "Large Private Fund Adviser") are subject to the most comprehensive reporting requirements. Initial reports on Form PF will be due for the period ending June 2012 for certain Large Private Fund Advisers (primarily hedge fund and liquidity fund managers with at least $5 billion in AUM) and for the period ending December 2012 for most other private fund advisers.

Who is required to file on Form PF?

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*) and has at least $150 million in regulatory AUM (effectively, gross assets under management plus uncalled capital commitments) attributable to private funds must file a Form PF with the SEC. A registered Commodity Pool Operator (a "CPO") or 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) 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 with greater than $150 million in private fund regulatory AUM, other than Large Private Fund Advisers to hedge funds and liquidity funds, are required to file Form PF annually within 120 days of the end of each fiscal year. Large Private Fund Advisers to hedge funds are required to file Form PF quarterly within 60 days of the end of each fiscal quarter. Large Private Fund Advisers to liquidity funds are required to file Form PF quarterly within 15 days of the end of each fiscal quarter. Advisers who must report on a quarterly basis because they manage at least one liquidity fund or hedge fund are only required to do so with respect to the type of fund or funds that caused them to exceed the reporting threshold (i.e., quarterly reporting would not be required with respect to a private equity fund also managed by such an adviser). Relative to the proposed rule, the final rule adopting Form PF reduced the frequency of reporting by Large

Private Fund Advisers to private equity funds (annually rather than quarterly) and increased the time hedge fund and private equity fund advisers have to file after the end of each reporting period.
The SEC adopted a two-stage phase-in period for initial compliance with the Form PF filing requirements. The following advisers have a compliance date of June 15, 2012:

- An adviser having at least $5 billion in regulatory AUM attributable to hedge funds as of the last day of the fiscal quarter most recently completed prior to June 15, 2012;
- An adviser managing a liquidity fund and having at least $5 billion in combined regulatory AUM attributable to liquidity funds and registered money market funds as of the last day of the fiscal quarter most recently completed prior to June 15, 2012; and
- An adviser having at least $5 billion in regulatory AUM attributable to private equity funds as of the last day of its first fiscal year to end on or after June 15, 2012.

For example, (i) an adviser with $5 billion in hedge fund regulatory AUM as of March 31, 2012, must file its first Form PF within 60 days following June 30, 2012, and (ii) an adviser having a December 31 fiscal year end and $5 billion in private equity fund regulatory AUM as of December 31, 2012 must file its first Form PF within 120 days following December 31, 2012.

For all other advisers, the compliance date is December 15, 2012 (i.e., these advisers must file their first Form PF in the first quarter of 2013 based on information as of December 31, 2012).

How does the new rule define the different categories of private funds and advisers subject to Form PF?

Form PF defines a **hedge fund** as any private fund (other than a securitized asset fund):

1. with respect to which one or more investment advisers (or related persons of investment advisers) may be paid a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses);

2. that 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 NAV (including any committed capital); or

3. that may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration).

In response to comments, the SEC (i) added an exception to the proposed “hedge fund” definition for funds that engage in short selling to hedge currency exposure or to manage duration and (ii) modified the performance fee provision so that it relates only to fees or allocations that may be *paid* to an investment adviser (or its related persons) in order to avoid unintentionally sweeping in certain private equity funds. Significantly, the SEC also noted in the adopting release that a private fund would not be deemed a “hedge fund” for purposes of Form PF solely because its organizational documents fail to prohibit the fund from borrowing or incurring derivative exposures in excess of the specified amounts or from engaging in short selling, so long as the fund in fact does not engage in these practices (other than short selling for the purpose of hedging currency exposure or managing duration) and a reasonable investor would understand, based on the fund’s offering documents, that the fund will not engage in these practices.

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Form PF 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.

Form PF 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 are subject to more comprehensive reporting requirements (described below), are defined in Form PF as:

1. **Large Hedge Fund Advisers:** Advisers managing hedge funds (including certain separately managed accounts, as described further below) that collectively have at least $1.5 billion in "regulatory assets under management" (as that term is defined in Form ADV)[1] that are attributable to hedge funds as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter;

2. **Large Liquidity Fund Advisers**: Advisers managing a liquidity fund and having combined regulatory assets under management that are attributable to liquidity funds *and registered money market funds* of at least $1 billion as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter; or

3. **Large Private Equity Fund Advisers**: Advisers managing private equity funds that collectively have at least $2 billion in regulatory assets under management that are attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year.

In response to comments, the SEC raised the dollar threshold for Large Hedge Fund Advisers from $1 billion to $1.5 billion and for Large Private Equity Advisers from $1 billion to $2 billion.

For purposes of measuring regulatory assets under management to determine whether the dollar thresholds for Large Private Fund Advisers have been crossed, hedge fund and liquidity fund advisers are required to make such calculations as of the end of each month (rather than daily as the SEC had previously proposed), and private equity funds are required to make such calculation annually (rather than quarterly as proposed) at the end of each fiscal year. In response to comments, the test adopted by the SEC for hedge fund and liquidity fund advisers looks back one quarter, so that these advisers will know at the start of each reporting period whether they will be required to complete the more detailed reporting required of Large Private Fund Advisers. Furthermore, for purposes of determining whether an adviser is a Large Private Fund Adviser, each adviser must 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") unless the value of those accounts exceeds the value of the private funds with which they are managed; and

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[1] In determining the value of regulatory assets under management, the instructions for Form ADV Part 1A require an adviser to a private fund to determine the current market value (or fair value) of the fund's gross assets and the contractual amount of any uncalled commitment pursuant to which a person is obligated to acquire an interest in, or make a capital contribution to, the fund.

2. Private fund or parallel managed account assets advised by any of the adviser's "related persons" (which includes all persons controlling, controlled by or under common control with the adviser) other than related persons that are separately operated (i.e., an adviser must aggregate with any related persons as set forth in Section 7.A. of Schedule D to such adviser's Form ADV Part 1A).[2]

The SEC acknowledged that the aggregation provisions in the proposed rule could cause an adviser managing a relatively small amount of private fund assets to cross a reporting threshold simply because it has a significant separate account business using a similar strategy. As a result, the final rule excludes parallel managed accounts if the value of those accounts is greater than the value of the private funds with which they are managed. Further, the rule as adopted excludes AUM of related persons that are separately operated in response to comments that advisers might have difficulty gathering the information necessary to aggregate the assets of related persons that have genuinely independent operations.

An adviser may, but is 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 should 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 is responsible for reporting on Form PF with respect to that fund).

Information Required on Form PF

Reporting Obligations of All Advisers to Private Funds

Rule 204(b)-1 requires all reporting advisers (i.e., those advisers with at least $150 million in regulatory AUM attributable to private funds), 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 requires identifying information of the adviser (including its large trader identification number, if any, obtained upon filing Form 13H), 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. An adviser also executes Form PF in Section 1a. In response to comments, the SEC removed the requirement in the proposed Form PF that the adviser certify "under penalty of perjury" that the statements made in Form PF are "true and correct".

A separate Section 1b is 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;
- A breakdown of the assets and liabilities of the fund using categories based on the fair value hierarchy established under U.S. generally accepted accounting principles;

[2] An adviser does not need to complete Section 7.A. of Schedule D for any related person if: (1) it has no business dealings with the related person in connection with advisory services it provides to its clients; (2) it does not conduct shared operations with the related person; (3) it does not refer clients or business to the related person, and the related person does not refer prospective clients or business to it; (4) it does not share supervised persons or premises with the related person; and (5) it has no reason to believe that its relationship with the related person otherwise creates a conflict of interest with its clients.

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- The value of the fund's investment in other private funds and of the parallel managed accounts managed alongside the fund;
- The approximate percentage of the fund beneficially owned by certain types of investors;
- The percentage of equity held by the five largest equity holders; and
- Monthly and quarterly performance information.

An adviser to a private fund that invests substantially all of its assets in the equity of private funds for which it is not an adviser (along with cash, cash equivalents and instruments acquired for hedging currency exposure) (i.e., a fund of funds) is only required to complete Section 1b for that fund and should disregard the fund for all other purposes. For example, where a question requests aggregate information regarding the private funds advised, the adviser should not include the assets or liabilities of any such fund.

In response to comments, the SEC added an instruction clarifying that an adviser may respond to the Form using its own methodologies and the conventions of its service providers, so long as the information is consistent with information that it reports internally and to current and prospective investors. However, those methodologies must be consistently applied and the adviser's responses must be consistent with any instructions or other guidance relating to the Form.

Reporting Obligations of Advisers to Hedge Funds

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

- The hedge fund's investment strategies and percentage of the fund's NAV represented by each strategy;
- The percentage of the fund's assets managed using high-frequency, 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 to hedge funds (i.e., those with at least $1.5 billion in hedge fund assets under management as of the last day of any month in the prior fiscal quarter) are required to complete Section 2 of Form PF. Section 2a requires 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, weighted average tenor or 10-year bond equivalent of fixed income portfolio holdings (including asset-backed securities);
- The value of turnover in certain asset classes in the adviser's portfolios during the reporting period; and
- The geographic breakdown of investments held.

Section 2b requires any adviser to a hedge fund with a NAV of at least $500 million (aggregating parallel funds, feeder funds, certain parallel separate accounts and funds of related persons) (a "qualifying hedge

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fund") to report additional information about any such fund it advises that is a qualifying hedge fund as of the end of any month in the prior fiscal quarter. This information must be reported separately for each qualifying hedge fund the adviser manages. Section 2b requires, for each qualifying hedge fund, reporting of:

- The market value of assets invested (on a short and long basis) in different types of securities and commodities;
- The fund's portfolio liquidity;
- The fund's base currency;
- Holdings of unencumbered cash;
- Information about each open position that represents 5% or more of the fund's NAV;
- The fund's collateral practices with significant counterparties;
- Whether the fund has cleared any trades directly through a central clearing counterparty during the reporting period;
- 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 (total notional derivatives exposure as well as the net mark-to-market value of its uncleared derivatives positions);
- The value of the collateral and other credit support posted in respect of the fund's secured borrowing and derivatives exposure;
- Types of creditors;
- The identity of, and amount owed to, each creditor to which the fund owed 5% or more of the fund's NAV;
- The term of any committed and uncommitted financing;
- Information about side pocket and gating arrangements; and
- A breakdown of outstanding investor lock-ups.

Reporting Obligations of Large Liquidity Fund Advisers

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 end of any month in the prior fiscal quarter) are 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 and NAV per share;
- The fund's weighted average maturity and weighted average life;
- The fund's 7-day gross yield;

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- 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 Large Private Equity Fund Advisers

Only Large Private Fund Advisers to private equity funds (i.e., those managing at least $2 billion in private equity fund assets as of the end of the most recently completed fiscal year) are required to complete Section 4 of Form PF. This section requires, for each private equity fund, reporting of:

- The guarantees of portfolio company obligations that the adviser, the reporting fund or any other related person of the adviser issues in respect of a portfolio company's obligations (including the dollar value of all such guarantees);
- The weighted average debt-to-equity ratio of "controlled portfolio companies"[3] in which the private equity fund invests, and the range of debt-to-equity ratios across controlled portfolio companies of the fund;
- The aggregate gross asset value of a fund's controlled portfolio companies;
- Total amount of borrowings categorized as current liabilities and as long-term liabilities on the most recent balance sheets of the fund's controlled portfolio companies;
- 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;
- The aggregate dollar amount of investment by the adviser or related persons (other than the reporting fund) in portfolio companies of the fund; and
- Information regarding any "financial industry portfolio company"[4] in which each private equity fund invests, including such financial industry portfolio company's name, debt-to-equity ratio, gross asset value and percentage of the portfolio company beneficially owned by the fund.

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[3] 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. Control of a portfolio company is generally presumed at 25% ownership of the company.

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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 final 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. The SEC may also share the information with other federal departments or agencies or with self-regulatory organizations, which would also be exempt from FOIA requests. Additionally the SEC would require any such department, agency or self-regulatory organization to represent that it has in place controls designed to ensure the use and handling of Form PF data in a manner consistent with the protections established in the Dodd-Frank Act.

Format for Reporting and Filing Fees

On September 30, 2011, the SEC issued notice of its determination that the Financial Industry Regulatory Authority will develop and maintain the filing system for Form PF as an extension of the existing Investment Adviser Registration Depository. The SEC in a separate order has approved filing fees of $150 for quarterly filings and annual filings.

Next Steps

Form PF is lengthy and complex (the form itself is 42 pages) and will require substantial efforts by private fund managers in advance of the compliance dates in order to be prepared to file completely and accurately. The SEC has provided time for such preparations: generally, large advisers to liquidity funds and hedge funds will be required to make their first filings in July and August, respectively, of 2012, and most other fund managers will not be required to make an initial filing on Form PF until early 2013. However, we recommend that private fund managers begin planning now for filing on Form PF, including by coordinating with back office personnel and service providers. The text of the final rule release is available here, and Form PF itself is available here.

Please contact your usual Ropes & Gray adviser with any questions about Form PF.

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[4] 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, savings association, bank holding company or financial holding company, savings and loan holding company, credit union, or other similar company regulated by a federal, state or foreign banking regulator.

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