

SEC PROPOSES FORM PF TO FACILITATE INCREASED PRIVATE FUND DISCLOSURE

INTRODUCTION

On January 26, 2011, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") jointly proposed new rules designed to monitor systemic risk to the financial system.¹ The proposed rules create Form PF, which would require registered investment advisers to private funds² to file information about the advisers' operations and the private funds they advise, such as the amount of assets under management, use of leverage, counterparty credit risk exposure and trading and investment positions for each private fund advised by the adviser. The amount of information reported and the frequency of reporting would depend upon the size of the private fund advised. This client alert summarizes the reporting requirements and types of disclosure required for proposed Form PF.

Overview of Systemic Risk Monitoring

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). While Dodd-Frank provides for wide-ranging reform of financial regulation, one stated focus of this legislation is to "promote the financial stability of the United States" by, among other measures, establishing better monitoring of emerging risks using a system-wide perspective. Title I of the Dodd-Frank Act establishes the Financial Stability Oversight Council (the "FSOC"), which is comprised of the leaders of

various financial regulators (including the Commissions' Chairmen) and other participants.

To further the monitoring of systemic risk, Sections 404 and 406 of Dodd-Frank amend Sections 204(b) and 211, respectively, of the Investment Advisers Act of 1940, as amended, to require private fund advisers to file reports containing information for the assessment of systemic risk by the FSOC. The records and reports must include a description of certain information about private funds, such as the amount of assets under management, use of leverage, counterparty credit risk exposure and trading and investment positions for each private fund advised by the adviser. Information reported on Form PF would not be available to the public, but Form PF information may be used by the SEC in an enforcement action or by FSOC as a basis for ordering further investigation by the Office of Financial Research.

Reporting Requirements

Beginning December 15, 2011, SEC-registered investment advisers that advise one or more private funds would be required to file Form PF. The form consists of 4 main sections.³ Section 1 must be completed by all private fund advisers. Sections 2-4 relate to private fund advisers of private funds in specific categories meeting certain assets under management thresholds.

Smaller private fund advisers (those advising private funds with total assets under management of less than \$1 billion in specific classes)⁴ would be

¹ Release No. IA-3145, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*, available at <http://sec.gov/rules/proposed/2011/ia-3145.pdf>

² A "private fund" is an issuer that would be an investment company under the Investment Company Act of 1940 but for the exemptions provided by section 3(c)(1) or 3(c)(7).

³ Section 5 is contemplated, but has not yet been proposed, as a hardship exemption form.

⁴ For purposes of calculating assets under management, each adviser would have to aggregate all parallel managed accounts and any assets advised by related persons. If the investment adviser's principal office and place of

required to complete and file Section 1 of Form PF annually no later than the last day on which the adviser may timely file its updating amendment to Form ADV (currently, 90 days after the end of the adviser's fiscal year).

Large private fund advisers (those advising private funds with total assets under management of \$1 billion or more in specific classes), on the other hand, face more frequent filing obligations and additional reporting requirements. Large private fund advisers would be required to complete and file Form PF quarterly, rather than annually, due no later than 15 days after the end of each calendar quarter. In addition to Section 1, a large private fund adviser with more than \$1 billion of hedge fund⁵ assets under management as of the close of business on any of the days during the reporting period would be required to complete Section 2. A large private fund adviser with more than \$1 billion of combined liquidity fund⁶ assets and registered money market fund assets under management as of the close of business on any of the days during the reporting period would be required to complete Section 3. Finally, a large private fund adviser with more than \$1 billion of private equity fund⁷ assets

business is outside the United States, it may disregard for Form PF purposes the assets of any private fund that is neither a U.S. person nor is offered to, or beneficially owned by, a U.S. person during the previous year.

⁵ 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.

⁶ A "liquidity fund" would be defined as 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. This includes, for example, treasury securities, municipal bonds, unsecured commercial paper, and certificates of deposit.

⁷ A "private equity fund" would be defined as any private fund that is not a hedge fund, liquidity fund, real estate

under management as of the last day of the quarterly reporting period would be required to complete Section 4.

The Commissions expect to implement an electronic filing system for Form PF, but have yet to propose a specific solution.⁸ Fees have also not yet been proposed.

Form PF Disclosure Requirements

The specific information requested in each Section of Form PF is outlined in more detail below.

SECTION 1

Section 1 must be filed by all private fund advisers.

Section 1a seeks information about the adviser, including:

- identifying information, such as its name and the name of any of its related persons whose information is also reported on the adviser's Form PF; and
- basic aggregate information about the private funds managed by the adviser, such as total and net assets under management and the amount of those assets that are attributable to certain types of private funds.

Section 1b requests information about each private fund advised by the investment adviser. The adviser would need to complete a separate section 1b for each private fund it advises⁹, covering:

- identifying and other basic information about each private fund;

fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course.

⁸ The most likely solution for electronic filings is expansion of the existing IARD system, owing to efficiencies "such as the possible interconnectivity of Form ADV filings and Form PF filings, and possible ease of filing with one password."

⁹ Funds that are part of a master-feeder arrangement would be filed together in order to avoid duplicative reporting.

- each private fund's gross and net assets and the aggregate notional value of its derivative positions;
- basic information about the fund's borrowings, including a breakdown based on whether the creditor is a U.S. financial institution, foreign financial institution or non-financial institution as well as 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; and
- monthly and quarterly performance data for each fund.

Section 1c would require information about hedge funds managed by the adviser. The adviser would need to complete a separate section 1c for each hedge fund it advised, disclosing:

- investment strategies;
- percentage of the fund's assets managed using computer-driven trading algorithms;
- significant trading counterparty exposures (including identity of counterparties); and
- detailed trading and clearing practices.

SECTION 2

Section 2 would apply to private fund advisers advising hedge funds with total assets under management of more than \$1 billion.

Section 2a seeks information about the adviser's hedge funds in the aggregate:

- exposure / market value of assets invested in different types of securities and commodities (on both short and long bases);
- duration of fixed income portfolio holdings;
- interest rate sensitivity;

- turnover rate of portfolios (to provide an indication of the adviser's frequency of trading); and
- geographic breakdown of investments.

Section 2b relates to each hedge fund advised by the investment adviser with at least \$500 million assets under management. The adviser would need to complete section 2b for each such fund, disclosing:

- exposure / market value of assets invested in different types of securities and commodities (on both short and long bases);
- portfolio liquidity;
- concentration of positions;
- collateral practices with significant counterparties;
- identity of, and clearing relationships with, the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure;
- certain hedge fund risk metrics;
- financing information;
- investor information;
- impact on the fund's portfolio from specified changes to certain identified market factors, (if regularly considered in the funds' risk management), broken down by long and short components of the portfolio;
- monthly breakdowns of secured and unsecured borrowing, derivatives exposures, information about the value of collateral and letters of credit supporting secured borrowing and derivatives exposures and the types of creditors;
- breakdown of the term of the funds' committed financing;
- investor composition and liquidity, such as side pocket, gating arrangements, and breakdowns of the percentage of the funds' net asset value that is locked in for different periods of time.

SECTION 3

Section 3 relates to private fund advisers advising liquidity funds and registered money market funds having combined assets under management of at least \$1 billion. Such advisers must disclose:

- pricing method for computer net asset value per share;
- compliance with Rule 2a-7 of the Investment Company Act of 1940;
- information regarding the fund's portfolio, such as
 - net asset value;
 - net asset value per share;
 - market-based net asset value per share;
 - weighted average maturity, weighted average life; and
 - 7-day gross yield, amount of daily and weekly liquid assets, amount of assets with a maturity greater than 397 days;
- amount of assets invested in different types of instruments, broken down by maturity, as well as information for each open position that represents 5% or more of the fund's net asset value;
- secured or unsecured borrowing of the fund, broken down by creditor type and maturity profile of that borrowing;
- whether the fund has in place a committed liquidity facility;
- concentration of the investor base;
- gating and redemption policies;
- investor liquidity; and
- percentage of the fund purchased using securities lending collateral.

SECTION 4

Section 4 covers private fund advisers advising private equity funds having assets under management of at least \$1 billion. Such advisers must disclose:

- information about borrowings and guarantees of the fund;
- leverage of the portfolio companies in which the fund invests;
- weighted average debt-to-equity ratio of controlled portfolio companies in which the fund invests and the range of debt to equity among those portfolio companies;
- maturity profile of portfolio companies' debt;
- whether fund or any portfolio companies experienced an event of default;
- identity of institutions providing bridge financing; and
- breakdown of the funds' investments by industry and by geography.

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