

## Alert

### Private Fund Systemic Risk Reporting

March 11, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) established the Financial Stability Oversight Council (“FSOC”), which has been tasked with monitoring systemic risk in the U.S. financial system. Dodd-Frank requires various agencies, including the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”), to assist the FSOC with its monitoring responsibilities.<sup>1</sup>

To this end, the SEC and CFTC issued proposed Rule 204(b)-1, under which Form PF<sup>2</sup> would be used to collect data about private funds<sup>3</sup> that will be shared with the FSOC for assessing systemic risk. Generally, Rule 204(b)-1 requires each investment adviser that is registered or required to be registered with the SEC under the Investment Advisers Act of 1940 (the “Advisers Act”) to report information about its private funds on Form PF at least once per year.<sup>4</sup> The amount and type of information and the frequency of the reporting requirements for an adviser vary based on the size and types of funds managed by the adviser.

While the SEC intends to use Form PF primarily as a confidential systemic risk disclosure tool to assist the FSOC in monitoring and assessing systemic risk, the SEC and the CFTC also may use information gathered from Form PF to assist with examinations, investigations and investor protection efforts related to private fund advisers, including in enforcement actions.<sup>5</sup>

It is important to point out that while the SEC has proposed Rule 204(b)-1 regarding Form PF, it has not yet proposed rules relating to the recordkeeping requirements under Section 404 of Dodd-Frank.

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<sup>1</sup> The FSOC will utilize this information to help determine which non-bank financial institutions should be subject to additional oversight. In testimony prepared for a Senate Banking Committee hearing, FDIC Chairman Sheila Bair reported that the risk council’s staff has divided the non-bank financial world into four sectors as it studies which firms could pose a risk to the financial system, one of which is specifically the hedge fund, private equity firm and asset management industries.

<sup>2</sup> Proposed Form PF is available at <http://www.sec.gov/rules/proposed/2011/ia-3145.pdf>.

<sup>3</sup> “Private fund” is defined in the Advisers Act as any fund that relies upon the exemptions from investment company registration under Sections 3(c)(1) and/or 3(c)(7) of the Investment Company Act.

<sup>4</sup> The CFTC has proposed rules that would require Commodity Pool Operators (“CPOs”) and Commodity Trading Advisors (“CTAs”) that are registered or required to be registered with the CFTC to file Forms CPO-PQR and CTA-PR, respectively, with the National Futures Association (“NFA”). The CFTC proposed Forms CPO-PQR and CTA-PR will solicit information identical to that sought through Form PF.

<sup>5</sup> The proposing release states that the SEC believes that Form PF should improve the efficiency of the SEC’s oversight of private fund advisers by enabling SEC staff to manage and analyze various information that would relate to risk more quickly and effectively than in the past, which should help the SEC more effectively target its examination program.

## Who Must File Form PF

### *Registered Investment Advisers*

All investment advisers that are registered or are required to register with the SEC under the Advisers Act must file Form PF if they manage private funds. There is no exemption from the filing requirements, even for smaller advisers. Advisers that are exempt from registration under the venture capital fund exemption, the private fund adviser exemption or the foreign private adviser exemption would not be subject to the Form PF filing requirements, although advisers relying on the venture capital fund exemption and private fund adviser exemption would still be subject to private fund reporting on Form ADV.<sup>6</sup>

### *Large Private Fund Adviser Thresholds*

Under the proposed rule, all registered investment advisers would be required to file basic information about their private funds annually and “Larger Private Fund Advisers” would be required to report additional information quarterly.<sup>7</sup> A “Large Private Fund Adviser” is an adviser with more than \$1 billion of assets under management (“AUM”) in any one of the following categories: (i) hedge funds, (ii) private equity funds and (iii) liquidity funds. Under the proposed rule, a manager would only be considered a Large Private Fund Adviser for a particular category if it has \$1 billion or more of AUM in that particular category. Accordingly, a manager could have \$900 million of AUM in hedge funds and \$900 million of AUM in private equity funds and not be considered a Large Private Fund Adviser for either category. In determining whether an adviser has in excess of \$1 billion of AUM for purposes of being a Large Private Fund Adviser, an adviser must aggregate all of its private funds that fall within a defined category.

Proposed Form PF defines a hedge fund as a private fund that:

- Has a performance fee or allocation calculated by taking into account unrealized gains;
- May borrow an amount in excess of one-half of its net asset value or may have gross notional exposure in excess of twice its net asset value; or
- May sell securities or other assets short.

Since the definition is broad, a fund that is structured with private equity terms (e.g., limited offering period with commitments from investors and performance compensation paid only on realized gains) may be considered a hedge fund for Form PF purposes if it has the ability to sell securities short.<sup>8</sup>

Additionally, advisers must aggregate (i) assets of managed accounts advised by the firm that pursue substantially the same investment objective and strategy and invest in substantially the same positions as their private funds (“parallel managed accounts”); (ii) assets of that type of private fund advised by any of the adviser’s “related persons”;<sup>9</sup> and (iii) for liquidity fund advisers, any registered money market fund assets.

As proposed, the \$1 billion AUM threshold would be measured on the last day of each quarterly reporting period for private equity funds; however, advisers to hedge funds and liquidity funds would be required to

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<sup>6</sup> See the release regarding the proposed exemptions from registration, [available here](#).

<sup>7</sup> See below under section “Proposed Information Included in Form PF” for a description of the information required by the proposed form.

<sup>8</sup> A “private equity fund” is defined 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. A “liquidity fund” is 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 maximize principal volatility for investors.

<sup>9</sup> “Related person” has the meaning provided in Form ADV and is defined generally as: (i) all of the adviser’s officers, partners, or directors (or any person performing similar functions); (ii) all persons directly or indirectly controlling, controlled by, or under common control with the adviser; and (iii) all of the adviser’s employees (other than employees performing only clerical, administrative, support or similar functions). Note that related person includes directors of the adviser (but not the directors of the funds). Accordingly, if the adviser is run by a board of directors or managers and one or more of the directors advises other private funds, there would be a requirement to aggregate the funds advised by the adviser with the other funds advised by the director.

determine whether they have crossed the \$1 billion AUM threshold on a daily basis. If an adviser crosses the \$1 billion AUM threshold for hedge funds on any day during a quarter, it would be required to make its initial filing as a Large Private Fund Adviser within 15 days of that quarter end. Once the adviser falls below the \$1 billion AUM threshold (either for an entire quarter with respect to hedge and liquidity funds, or as of the end of quarter with respect to private equity funds), it will be required to make a filing no later than 15 days after that quarter end to transition from a Large Private Fund Adviser to a smaller adviser.

### *Reporting for Affiliated and Sub-Advised Funds*

The proposed rule seeks to take measures to avoid duplicative filings and provides some flexibility and convenience so that the reports can more accurately assist with the stated goal of monitoring systemic risk. Advisers are given the option to file one form for the adviser and its related persons as opposed to multiple forms by each person. Affiliated entities that share reporting and risk management systems could file jointly and affiliated entities that operate separately may opt to report separately. Additionally, sub-advisers to funds are not required to separately file a Form PF for those funds. Instead, the investment adviser that is required to report the private fund on Schedule D of its Form ADV is the adviser that is required to file the Form PF for the private fund.

### *Fund of Funds and Non-U.S. Funds*

Fund of funds are disregarded for purposes of determining whether an adviser is a Large Private Fund Adviser and for the detailed reporting regarding private funds. While advisers are required to complete certain basic identifying information about their fund of funds, where questions on the proposed form ask for aggregate information regarding private funds, advisers will not include the assets and liabilities of their fund of funds. An adviser with a principal office and place of business outside the U.S. may exclude a private fund that was not, during the last year, itself a U.S. person (e.g., formed under the laws of a U.S. jurisdiction) or offered to or beneficially owned by any U.S. person. This approach is distinguishable from the approach taken by the SEC with respect to the proposed private fund adviser exemption from registration as an investment adviser,<sup>10</sup> under which a non-U.S. adviser is required only to count its private fund clients managed from a U.S. place of business to determine whether it is eligible for the private fund adviser exemption. The proposed form requires inclusion of a private fund based on the jurisdiction where it is offered and on its beneficial owners in addition to the jurisdiction of the adviser's principal place of business.

### **Timing of Filings**

Large Private Fund Advisers would be required to file within 15 days after the end of each calendar quarter. Currently, the rule is proposed to become effective on Dec. 15, 2011, which would result in Large Private Fund Advisers having to make their initial filing by Jan. 15, 2012 and smaller advisers with a fiscal year end of Dec. 31 having to make their initial filing by March 31, 2012. A newly registering adviser (small or large) will have to submit its initial Form PF within 15 days of the end of the next occurring calendar quarter.<sup>11</sup> Annual updates for smaller advisers would be due at the same time that the adviser is required to file its annual update to its Form ADV, which currently is 90 days after the end of such adviser's fiscal year.

### **Confidentiality**

The information gathered through Form PF generally is expected to be kept confidential, *although the SEC may use Form PF information in an enforcement action*. Under Section 404 of Dodd-Frank, the information is exempt from Freedom of Information Act ("FOIA") requests. The information is required to be shared with FSOC, and the SEC expects to share the information with international regulators in an effort for international coordination in the monitoring of systemic risk.<sup>12</sup> In addition, Section 404 of Dodd-Frank does not prevent the SEC from complying with requests from other federal departments and agencies and self-regulatory

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<sup>10</sup> See Footnote 6 for a link to the release regarding the proposed exemptions from registration.

<sup>11</sup> Presumably, this means the end of the next full calendar quarter after registering as an investment adviser, but hopefully this will be clarified by the SEC.

<sup>12</sup> Information shared with foreign financial regulators are expected to be shared under agreements pursuant to which the foreign regulator agrees to keep the information confidential.

organizations regarding information gathered on Form PF, and the SEC may share such information in connection with any such requests.<sup>13</sup>

## **Proposed Information Included in Form PF**

### *International Coordination*

The questions contained in Form PF ultimately reflect the requirements and considerations under Dodd-Frank, consultations with staff representing FSOC's members and the SEC's experience in regulating private fund advisers that are already registered with the SEC. Additionally, the staffs of the SEC and CFTC consulted with various international regulators, including through participation in an international effort coordinated by the International Organization of Securities Commissions ("IOSCO"). Form PF incorporates many of the types of information that are already collected by the U.K.'s Financial Services Authority ("FSA") through its surveys and is consistent with the types of information that IOSCO recommended that regulators should gather from hedge fund advisers. Ultimately, the information collected under Form PF is aimed to help facilitate the sharing of consistent information internationally for systemic risk assessment purposes. Hopefully, a consistent format will be adopted by the SEC, FSA and other relevant regulators for data requested on Form PF and similar forms of other regulators.

### *Information Required from All Form PF Filers*

Each registered investment adviser that manages one or more private funds would be required to report basic information about the adviser in Section 1a, information about each private fund in Section 1b and more specific information about hedge funds in Section 1c.<sup>14</sup> The data to be provided in the filings will be calculated based on information about the private fund as of the end of the applicable quarter or year and for transactions occurring during the reporting period, as indicated in the instructions for Form PF. Section 1a requires:

- Basic identifying information of the adviser, including the names of any related persons included on the Form PF;
- Aggregate AUM broken down by fund type; and
- A certification, under penalty of perjury, regarding the accuracy of the information contained in the Form PF executed by a duly authorized member of the firm. An adviser should retain backup data to support information reported on its Form PF (including data based on estimates (as permitted for certain questions)), which may be needed in the event it is required to justify the information contained in its filing.

Section 1b must be completed for each private fund managed by the adviser, except that funds that are part of a master-feeder structure must be reported in Section 1b on an aggregated basis to prevent duplicative reporting.<sup>15</sup> Section 1b requires:

- Gross and net asset value of each private fund;
- Gross notional amount of all derivative positions;
- Total borrowings<sup>16</sup> of the fund, including name and amount for each creditor owed at least 5 percent of the fund's net asset value as of the data reporting date;

<sup>13</sup> Unlike Form PF, Forms CPO-PQR and CTA-PR are not expressly exempt from FOIA under Dodd-Frank, however in the proposing release, the CFTC says the information submitted in Forms CPO-PQR and CTA-PR will be treated as exempt from the disclosure requirements of FOIA as "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4).

<sup>14</sup> Similar information is required on Schedule A part 1 and part 2 of Form CPO-PQR/CTA-PR.

<sup>15</sup> Parallel funds are reported separately for purposes of Sections 1b, 1c, 2b, 3 and 4, with assets of any parallel managed account to be aggregated with the largest, corresponding parallel fund.

- Investor concentration information, including total number of beneficial owners and combined percentage equity owned by the five largest beneficial owners; and
- Monthly and quarterly fund performance information expressed both net and gross of performance-based compensation.

Section 1c must be completed for each hedge fund managed by the adviser (except that funds that are part of a master-feeder structure are aggregated). Section 1c requires:

- Fund name and strategy;
- Approximate percentage of the fund's net asset value that is managed using computer-driven trading algorithms;
- Name and amount for each of (i) the five trading counterparties (including prime brokers) to which the fund has the greatest net counterparty credit exposure and (ii) the five trading counterparties with the greatest net counterparty credit exposure to the fund;
- Estimated percentages of securities, derivatives and repos traded during the reporting period and whether or not they were cleared.

#### *Information Required from Large Private Fund Advisers*

Large Private Fund Advisers are required to file Form PF quarterly and are subject to heightened disclosure requirements based on the types of private funds it advises. This *Alert* describes the information required by Large Private Fund Advisers to hedge funds, which are required to complete Section 2 of Form PF, and Large Private Fund Advisers to private equity funds, which are required to complete Section 4 of Form PF.<sup>17</sup>

Hedge Funds. All Large Private Fund Advisers to hedge funds are required to complete Section 2a, which requires information on an aggregated basis for all of the hedge funds managed by the adviser. Section 2a requires:

- The market value of financial instruments held by the hedge funds broken down into a number of asset classes set forth in the proposed form (e.g., equities, equity derivatives, corporate bonds, convertible bonds, sovereign bonds, loans, repos, ABS/structured products, credit derivatives, FX derivatives, commodities and investments in other asset classes);
- Monthly turnover rate on an aggregated basis;<sup>18</sup> and
- Geographical breakdown of investments. Investments would be reported by the jurisdiction of organization of the issuer or counterparty, as applicable.

Hedge Funds with a Net Asset Value in Excess of \$500 Million. The proposed rule requires a Large Private Fund Adviser to disclose additional information about any individual hedge fund with a net asset value in excess of \$500 million in Section 2b ("Qualifying Hedge Funds"). In determining whether an individual fund has a net asset value in excess of \$500 million, an adviser must aggregate assets of any private fund that are part of the same (i) master-feeder structure or (ii) parallel fund structure, including any parallel managed accounts. The proposed rule does not require a smaller adviser that manages a hedge fund with a net asset value in excess of \$500 million to file Section 2b. Section 2b must be completed for each hedge fund

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<sup>16</sup> "Borrowings" are defined as (i) obligations for borrowed money in respect of which the borrower has posted collateral or other credit support (including reverse repos) and (ii) obligations for borrowed money in respect of which the borrower has not posted collateral or other credit support.

<sup>17</sup> Large Private Fund Advisers to liquidity funds can find the information required to be reported in Section 3 of Form PF. See Footnote 3 for a link to the proposed Form PF.

<sup>18</sup> See the Glossary of Terms in the proposed Form PF for a definition of turnover rate.

managed by the adviser (except that funds that are part of a master-feeder structure are aggregated). Section 2b requires extensive information about each Qualifying Hedge Fund, including:

- The market value of financial instruments held by the hedge funds broken down by asset class;
- Asset class for each position that represents 5 percent or more of the net asset value;
- Collateral practices of any significant counterparties listed in Section 1c;
- Name and exposure by percentage of net asset value of the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure;
- If calculated by the fund, information regarding calculation of a value at risk (“VaR”) metric and report broken down monthly;
- Estimated impact of various market factors (e.g., equity prices, interest rates, credit spreads, currency prices, commodity prices, option volatility and default rates) that the fund regularly considers in its risk management;
- Financing information including monthly breakdown of secured and unsecured creditors, borrowing and derivative exposures as well as information about the value of collateral and letters of credit supporting the secured borrowing and the derivatives exposures and types of creditors; and
- Fund investor makeup and liquidity terms, including use of side-pockets, restrictions on withdrawals/redemptions and estimation of how soon investors could exit the fund, including if the fund has the right to impose these restrictions and whether any restriction has been imposed as of the reporting date.

Private Equity Funds. Section 4 must be completed for each private equity fund managed by a Large Private Fund Adviser (except that funds that are part of a master-feeder structure are aggregated). Section 4 requires information regarding private equity funds, including:

- The outstanding balance of all loans and borrowing facilities;
- The extent to which the fund guarantees the obligations of any portfolio company;
- Information concerning “controlled portfolio companies”;<sup>19</sup>
- A breakdown of the fund’s investments by industry and by geography; and
- The aggregate dollar amount of investments by related persons in portfolio companies in which the fund invests.

Additionally, Section 4 contains the only question on Form PF that requires the name of a position held by a private fund. Large Private Fund Advisers to private equity funds are required to disclose the name of any financial industry portfolio company<sup>20</sup> in which the reporting fund invests.

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<sup>19</sup> 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.

<sup>20</sup> A “financial industry portfolio company” is defined as any of the following: (i) a nonbank financial company, as defined in the Financial Stability Act of 2010; or (ii) a financial institution as defined in the Glossary of Terms in the proposed Form PF.

## Filing Mechanics

Form PF will be filed with the SEC through an electronic system designated by the SEC for this purpose. However, the SEC has not yet decided on the system to be used. Advisers that are required to file Form PF would be required to pay the operator of the Form PF filing system fees, the amount of which is anticipated to be based on the amount of information required to be filed by an adviser. Filing fees and the establishment of a filing system will be decided upon on a later date and set forth in a separate release.

The proposed rule only purports to address the reporting requirements of Section 404 of Dodd-Frank. Recordkeeping requirements specific to private fund advisers for systemic risk assessment purposes are to be addressed in a future release.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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