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## SEC Adopts Private Fund Risk Reporting

Client Alert

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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"). The new rule will require SEC-registered advisers with at least \$150 million in assets under management attributable to private funds to report certain information to the SEC on newly created Form PF.

The information provided under this new reporting obligation will be treated as confidential. It will be used primarily by the Financial Stability Oversight Council to assess systemic risks to the U.S. financial system.

### Scope and Applicability of Form PF Reporting Requirements

The frequency of the reporting obligation and the amount of information that must be reported on Form PF will vary depending on the size of the adviser and on the type of private funds managed by the adviser.

In general, any registered investment adviser that advises one or more private funds and has at least \$150 million in assets under management attributable to those private funds (a "Reporting Adviser") will be required to file a Form PF with the SEC on an annual basis.<sup>[1]</sup> However, the reporting requirements for hedge funds will be more extensive than the reporting requirements for other types of private funds.

In addition, the reporting requirements for certain large Reporting Advisers will be more frequent and/or more extensive. In particular:

- Reporting Advisers with at least \$1.5 billion in assets under management attributable to hedge funds ("Large Hedge Fund Advisers") will be subject to more comprehensive quarterly reporting requirements regarding their hedge fund investment activities;
- Reporting Advisers with at least \$1.0 billion in assets under management attributable to private liquidity funds and registered money market funds ("Large Liquidity Fund Advisers") will be subject to more comprehensive quarterly reporting requirements regarding their private liquidity fund investment activities; and
- Reporting Advisers with at least \$2.0 billion in assets under management attributable to private equity funds ("Large Private Equity Fund Advisers") will be subject to more comprehensive annual reporting requirements relating to their private equity fund investment activities.

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## Practices

## Offices

"exempt reporting advisers" under the Advisers Act will not be required to file a Form PF.<sup>[2]</sup>

For purposes of these reporting requirements:

- A "private fund" is defined as any fund that is exempt from registration under the Investment Company Act of 1940 (the "Investment Company Act") in reliance on either section 3(c)(1) (privately offered funds with no more than 100 beneficial owners in the fund) or 3(c)(7) (privately offered funds the securities of which are owned by "qualified purchasers").
- A "hedge fund" is defined as any private fund (other than a securitized asset fund<sup>[3]</sup>) that:
  - pays a performance fee or allocation, the calculation of which may take into account unrealized gains;
  - may borrow an amount in excess of 50% of its net asset value (including any uncalled committed capital) or that may have a gross notional exposure in excess of twice its net asset value (including any uncalled committed capital); or
  - may sell securities or other assets short (other than for the purpose of hedging currency exposure or managing duration).
- 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 minimize principal volatility for investors.
- A "private equity fund" is defined as any private fund that:
  - is not a hedge fund, liquidity fund, real estate fund, <sup>[4]</sup> securitized asset fund<sup>[5]</sup> or venture capital fund; <sup>[6]</sup> and
  - does not offer redemption rights in the ordinary course.

For purposes of determining whether an adviser's private fund assets under management exceed a particular reporting threshold, Form PF provides that an adviser must calculate its assets under management attributable to private funds in accordance with the requirements of Part 1A of Form ADV. In general, this requires advisers to include as assets under management the gross value of all assets in a private fund (regardless of the nature of those assets) plus any uncalled capital commitments to the fund.<sup>[7]</sup>

For purposes of Form PF:

- an adviser generally must aggregate the assets of any parallel funds, "dependent managed parallel accounts"<sup>[8]</sup>

and master-feeder fund arrangements, as well as any funds managed by a related person unless the related person is "separately operated";

- private fund assets invested in other private funds may be disregarded for certain purposes; and
- an adviser with a principal office and place of business located outside the United States generally may disregard any private fund that during the last fiscal year was not: (i) a U.S. person,<sup>[9]</sup> (ii) offered to a U.S. person or (iii) beneficially owned by a U.S. person.

A Reporting Adviser may (but is not required to) file a single Form PF with respect to all of its related persons and the private funds they advise, so long as the Reporting Adviser identifies all related persons included in the filing.

Several interesting consequences arise from the manner in which the SEC has chosen to define the terms "private equity fund" and "hedge fund" under Form PF. For example, a private equity fund is defined as any private fund that does not fall into one of the SEC's other private fund categories. This raises the possibility that some private fund advisers that do not consider themselves to be private equity firms will nevertheless find themselves included in the private equity category simply because their investment products do not fit neatly into one of the SEC's other categories under Form PF. Perhaps more importantly, any fund that meets the definition of a hedge fund must report as a hedge fund for purposes of Form PF and may not be classified as a private equity fund. Significantly, the SEC noted in the Adopting Release that a fund's governing documents do not need to expressly prohibit the types of borrowing or short sale activities that are included in the definition of a hedge fund in order for a fund to avoid being treated as a hedge fund, so long as the fund does not actually engage in such activities and no reasonable investor would expect the fund to engage in such activities based on the fund's offering documents. Nevertheless, private equity and other non-hedge fund advisers should carefully review their activities and fee structures against Form PF's definitions to understand properly how their funds will be characterized for purposes of Form PF and to ensure that their funds will not be inadvertently caught up in the reporting requirements for hedge funds.

### **Reporting Obligations under Form PF**

#### *(a) All Reporting Advisers*

Reporting Advisers (those whose assets under management attributable to private funds are at least \$150 million as of the last day of the adviser's fiscal year) will be required to file Form PF with the SEC within 120 days of the end of the adviser's fiscal year. The basic reporting requirements for all Reporting Advisers under Form PF are as follows:

- Section 1a of Form PF requires a Reporting Adviser to provide information regarding its business, including:
  - the Reporting Adviser's name and other identifying information; and
  - the Reporting Adviser's gross and net assets under management attributable to various categories of private funds managed by the adviser.
  
- Section 1b of Form PF requires a Reporting Adviser to provide information with respect to each of its private funds, including
  - the name and other identifying information of the private fund;
  - certain information regarding the assets, leverage and investor concentration of the fund (including gross and net asset value, the amount of the fund's borrowings, the nature of its lenders, the value of any outstanding derivatives positions held by the fund, the nature of the fund's assets,<sup>[10]</sup> the approximate percentage of the fund owned by its top five investors and the general composition of the fund's investor base); and
  - certain information relating to the private fund's gross and net investment performance.<sup>[11]</sup>
  
- Section 1c of Form PF requires a Reporting Adviser to provide certain additional information with respect to each of its hedge funds, including:
  - the types of investment strategies that the hedge fund pursues (including whether the fund engages in any high frequency trading strategies);
  - more detailed information relating to the hedge fund's counterparty credit exposure; and
  - more detailed information relating to the hedge fund's trading activities.

*(b) Large Hedge Fund Advisers*

Large Hedge Fund Advisers (those whose assets under management attributable to hedge funds are at least \$1.5 billion as of the end of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter) will be required to file Form PF on a quarterly basis within 60 days of the end of each fiscal quarter. In addition to the basic information required under section 1 of Form PF for all Reporting Advisers, section 2 of Form PF requires Large Hedge Fund Advisers to provide more detailed

information concerning their hedge funds' investment activities, including:

- on a firm-wide basis:
  - the Reporting Adviser's aggregate hedge fund exposures to various types of investment classes;
  - the Reporting Adviser's monthly turnover value in various investment classes; and
  - the aggregate geographic breakdown of the Reporting Adviser's hedge fund investments.
- In addition, each hedge fund managed by a Large Hedge Fund Adviser that has a net asset value of at least \$500 million as of the end of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter must provide:
  - the name and other identifying information relating to the fund;
  - the fund's exposure to various types of investment classes;
  - information relating to the liquidity of the fund's portfolio;
  - information relating to each open position held by the fund that represents more than 5% of the fund's net asset value;
  - information relating to the fund's counterparty exposures;
  - information relating to certain risk metrics for the fund (including value at risk (VaR) and the potential impact of certain specified changes in market factors on the long and short components of the fund's portfolio);
  - information relating to the fund's borrowing activities (including the dollar amount and nature of the fund's borrowings and the identities of the fund's lenders); and
  - information relating to the fund's investors (including the percentage of the fund's assets that are subject to "side pocket arrangements," the nature of the fund's restrictions on investor withdrawals and redemptions, and a breakdown of the fund's assets based on the number of days' notice the fund's investors would need to give in order to withdraw

assets from the fund).

*(c) Large Liquidity Fund Advisers*

Large Liquidity Fund Advisers (those whose assets under management attributable to private money market funds and registered money market funds are at least \$1.0 billion as of the end of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter) must file Form PF within 15 days of the end of each fiscal quarter. In addition to the basic information required under section 1 of Form PF for all Reporting Advisers, section 3 of Form PF requires Large Liquidity Fund Advisers to provide more detailed information concerning each of their private liquidity funds, including:

- the name and certain identifying and operational information for the fund (including whether the fund uses the amortized cost and/or penny rounding methods to calculate its net asset value, and whether the fund has a policy of complying with the risk limiting conditions of Rule 2a-7 under the Investment Company Act);
- information relating to the fund's assets (including monthly data relating to the fund's size, portfolio characteristics, and types of assets in which the fund invests);
- information relating to the fund's financing activities (including whether the fund borrows amounts in excess of 5% of its net asset value and, if so, the nature of the fund's borrowing activities and lenders); and
- information relating to the fund's investors (including the level of investor concentration, an estimate of the percentage of the fund's equity that was purchased using securities lending collateral, and the nature of the fund's investor liquidity).

*(d) Large Private Equity Fund Advisers*

Large Private Equity Fund Advisers (those whose assets under management attributable to private equity funds are at least \$2.0 billion as of the last day of the adviser's most recently completed fiscal year) must file a Form PF within 120 days of the end of the adviser's fiscal year. In addition to the basic information required under section 1 of Form PF for all Reporting Advisers, section 4 of Form PF requires Large Private Equity Fund Advisers to provide more detailed information concerning each of their private equity funds, including:

- identifying information for the fund; and
- information relating to the fund's portfolio companies, including:

- the extent to which the fund, the Large Private Equity Fund Adviser or its related persons provides any guarantees or other commitments to satisfy the obligations of the fund's portfolio companies;
- the weighted average debt-to-equity ratio of the fund's "controlled portfolio companies"<sup>[12]</sup> and the range of debt-to-equity ratios of the fund's portfolio companies from highest to lowest;
- the aggregate gross asset value of the fund's controlled portfolio companies, the aggregate principal amount of its controlled portfolio companies' borrowings that are classified on their balance sheets as current and long-term liabilities, respectively, and the percentage of aggregate borrowings that are classified as payment-in-kind or zero-coupon debt;
- the extent to which the fund's controlled portfolio companies have any bridge loans (or commitments for any bridge loans) in place and, if so, the names of the counterparties supplying the bridge financing, the total size of each commitment and the amount drawn down under each commitment;
- whether the fund has invested in any controlled portfolio companies that are in the financial industry and, if so, detailed information relating to the identity, debt-to-equity ratio and gross asset value of the portfolio company, percentage of the fund's assets invested in the portfolio company and percentage of the portfolio company owned by the fund;
- breakdowns of the fund's portfolio company investments by industry sector and geographic location; and
- whether the Large Private Equity Fund Adviser (or any of its related persons) has invested in the fund's portfolio companies and the aggregate dollar amount of such investments.

### **Compliance Deadlines**

There is a two-stage phase-in period for compliance with the Form PF filing requirements. Reporting Advisers with:

- at least \$5 billion in assets under management attributable to hedge funds;
- at least \$5 billion in assets under management attributable to private liquidity funds and registered money market funds;

or

- at least \$5 billion in assets under management attributable to private equity funds;

must file Form PF beginning with the first fiscal quarter or fiscal year, as applicable, to end on or after June 15, 2012.

All other Reporting Advisers must begin filing Form PF following the end of their first fiscal quarter or fiscal year, as applicable, to end on or after December 15, 2012.

The filing fee for Form PF will be \$150 for each quarterly or annual filing.

The paper version of Form PF is available on the SEC's Web site at: <http://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf>. If you have any questions concerning Form PF, please contact your Proskauer relationship attorney.

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[1] Reporting Advisers that (i) also are registered with the CFTC as a commodity pool operator or commodity trading adviser and (ii) are otherwise subject to a reporting obligation under Rule 204(b)-1, will be permitted to use a Form PF filing with the SEC as substitute compliance for certain additional systemic risk reporting rules that the CFTC has proposed (but not yet adopted) under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[2] See Proskauer Client Alert, "SEC Adopts Final Rules for Advisers to Private Investment Funds and Amendments to Form ADV" (July 11, 2011) for a discussion of the requirements to qualify as an exempt reporting venture capital fund adviser under the Advisers Act.  
<http://www.proskauer.com/publications/client-alert/sec-adopts-final-rules-for-advisers-to-private-investment-funds/>

[3] A "securitized asset fund" is defined as any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders.

[4] A "real estate fund" is defined as any private fund that is not a "hedge fund," that does not provide investors with redemption rights in the ordinary course, and that invests primarily in real estate and real estate-related assets.

[5] See footnote 3 above.

[6] A "venture capital fund" is defined as any private fund meeting the definition of a venture capital fund under Rule 203(1)-1 under the Advisers Act. See footnote 2 above.

[7] In calculating regulatory assets under management on a

gross basis, an adviser may not deduct any liabilities that a private fund may have (such as accrued fees or expenses or the amount of any borrowings).

[8] A "dependent managed parallel account" is defined as any managed account or other pool of assets managed by the applicable Reporting Adviser that pursues substantially the same investment objective and strategy and invests side-by-side in substantially the same positions as the identified private fund (other than a managed parallel account or group of accounts whose gross value is greater than the identified private fund or group of parallel private funds). According to the SEC, this exception for managed parallel accounts whose value exceeds the value of the referenced private funds is intended to prevent an adviser with a relatively small amount of private fund assets from becoming subject to the reporting requirements under Form PF simply because it manages a large number of separate accounts that pursue the same investment strategy as the adviser's private fund(s).

[9] As defined in Advisers Act Rule 203(m)-1.

[10] Specifically, Form PF requires Reporting Advisers to provide a breakdown of each private fund's assets based on the fair value hierarchy categories established under U.S. Generally Accepted Accounting Principles.

[11] The instructions to Form PF provide that for any private fund that invests substantially all of its assets in other unaffiliated private funds (a "fund-of-funds"), the Reporting Adviser is only required to complete section 1b of Form PF for that fund and that for all other purposes the fund-of-funds should be disregarded.

[12] A "controlled portfolio company" is defined as a company that is controlled by the private equity fund, either alone or together with the private equity fund's affiliates or other persons that are part of a club or consortium that includes the private equity fund. "Control" is defined by reference to Form ADV, which defines control as the power, directly or indirectly, to direct the management or policies of a portfolio company, whether through ownership of securities, by contract or otherwise. Control is generally presumed to exist with an ownership interest of 25% or greater.