SEC and CFTC Propose Rules to Expand Reporting by Private Fund Advisers

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Registered investment advisers to private funds (including hedge funds and private equity funds) may soon be required to report sensitive proprietary information about the private funds they manage to the US Securities and Exchange Commission (SEC) if new rules proposed by the SEC and the US Commodity Futures Trading Commission (CFTC) are adopted. The proposed rules would require information about a private fund to be reported on Form PF, in some cases as soon as 15 days after the end of a calendar quarter. The level of detail required will vary depending on the type and size of private fund. Comments are due April 12, 2011.

Unlike information on Form ADV, information on Form PF would not be made available to the public, would be exempt from disclosure under the Freedom of Information Act, and would be protected under additional confidentiality provisions in Section 404 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Nonetheless, the information gathered on Form PF would be filed electronically and would be shared with the Financial Stability Oversight Council (FSOC) to facilitate its assessment of systemic risk in the US financial system. In addition, such information could be used by the SEC in examinations, investigations, and enforcement actions; could be shared with Congress, federal and foreign regulatory authorities, and self-regulatory organizations; and could be disclosed pursuant to an order of a US court in an action brought by the United States or the SEC.

A. The Scope of the New Reporting Requirements

What Funds Are Covered. Proposed Rule 204(b)-1 under the Investment Advisers Act of 1940 (Advisers Act) would require that all registered investment advisers report information to the SEC about the private funds they manage on Form PF if they advise at least one private fund. In addition, Form PF could be used by registered advisers that also are registered with the CFTC as commodity pool operators or commodity trading advisers that manage a commodity pool that constitutes a private fund to satisfy certain systemic reporting requirements under proposed CFTC Rule 4.27(d). These private fund advisers would file Form PF with both the SEC and CFTC. Advisers solely to venture capital funds, advisers to private funds with less than

US$150 million in assets under management that are exempt from Advisers Act registration, and "foreign private advisers" that are not required to register with the SEC would not be required to complete Form PF. A private fund would be defined as an entity that is excluded from the definition of an "investment company" by virtue of the exclusions provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act).

Fund Size Matters. The amount and timing of the reporting obligations will depend on whether a registered private fund adviser is a large private fund adviser (with at least US$1 billion in private fund assets under management) or a small adviser. "Large private fund advisers" will be required to provide more disclosures than small advisers on Form PF and will need to file Form PF on a quarterly basis within 15 days of the end of a calendar quarter. Smaller advisers will only be required to file Form PF on an annual basis and update the filing as of 90 days after the end of the adviser's fiscal year.

To determine whether an adviser is a "large private fund adviser" because it has US$1 billion or more in private fund assets under management, an adviser must aggregate the private fund assets it manages with the assets of managed accounts that have substantially the same investment objectives, strategies, and positions as the private funds. Also, assets of private funds managed by related persons must be aggregated if the private funds they manage have substantially the same investment objectives, strategies, and positions. As a result, private fund advisers will need to communicate closely with their related persons managing private fund assets to determine whether they cross the US$1 billion assets threshold in any given quarter.

Advisers to "hedge funds" and "liquidity funds" (i.e., private funds that are substitutes for registered money market funds but are not subject to the extensive regulation to which registered money market funds are subject) would need to assess whether they have US$1 billion in hedge fund assets or liquidity fund assets each day of a calendar quarter. In contrast, because of the illiquid nature of private equity investments, advisers to private equity funds would only be required to determine whether they have US$1 billion or more in private equity fund assets under management at the end of a calendar quarter. Due to fluctuations in the value of private fund portfolios, advisers that cross the US$1 billion assets threshold near the end of a calendar quarter could find themselves in a position of having to file an initial Form PF with little time to implement procedures to ensure that all information required to be reported on Form PF would be available to them.

Commencement Date. As proposed, large private fund advisers would be required to make their first Form PF filing as of January 15, 2012, while small advisers with a fiscal year end of December 31 would be required to make their first Form PF filing as of March 31, 2012.

B. Information Required To Be Reported on Form PF

All private fund advisers would be required to complete Sections 1a and 1b of Form PF, which requests identifying information about the private fund adviser and related persons who also are reporting on the adviser's Form PF. Section 1a also requires information about the total and net private fund assets under management as well as a breakdown of assets attributable to certain types of private funds. Section 1b would require certain information about each private fund managed by the private fund adviser, including: (a) the fund's name; (b) gross and net assets under management and aggregate notional value of derivative positions; (c) monthly and quarterly performance information; (d) information about the fund's borrowings, including a breakdown by lender type as well as the identity of, and amount owed to, each creditor to which the fund owed an amount equal to or greater than five percent of the fund's net asset value; and (e) the number of beneficial owners of the private fund's equity and the percentage of the private fund's equity owned by the five largest equity holders. Private fund advisers would be required to complete a separate Section 1b for each private fund managed although private funds structured as a master-feeder complex could be reported together.

Other disclosures required by Form PF depend on the type of private fund managed by the private fund adviser as well as whether the adviser is a large private fund adviser or a small adviser. For instance, Section 1c would be completed by advisers managing hedge funds and would require disclosures relating to: (a) investment strategies; (b) percentage of assets managed using computer-driven trading algorithms; (c) significant trading counterparty exposures, including names of the five trading counterparties to which the fund has the greatest net counterparty credit exposure and the five trading counterparties that have the greatest net counterparty credit exposure to the fund; and (d) trading and clearing practices.

Section 2 would mandate additional disclosures by advisers with hedge fund assets under management of US$1 billion or more. More specifically, Section 2a would require aggregate information about the hedge funds being advised, such as: (a) the market value of assets invested (short or long) in certain categories of securities and commodities; (b) the duration of fixed-income investments (including asset-backed securities), to indicate the assets' interest-rate sensitivity and the turnover rate of aggregate portfolios during the reporting period to provide an indication of the adviser's frequency of trading; and (c) a geographical breakdown of investments held. Section 2b would require disclosure of information about each hedge fund with a net asset value of US$500 million or more as of the close of business on any day during the most recently completed calendar quarter (a "qualifying hedge fund") including information about: (a) the fund's long and short positions; (b) portfolio liquidity; (c) portfolio concentration (including identification of positions constituting more than five percent of a fund's net asset value); (d) collateral practices with significant counterparties; (e) names of the three largest central clearing counterparties to which the fund has the greatest net counterparty credit exposure; (f) risk metrics, including disclosure of value at risk if regularly calculated by the fund; (g) monthly breakdown of the fund's secured and unsecured borrowings and derivatives as well as collateral supporting such borrowings and derivatives; and (h) information about investor composition and liquidity, including a breakdown of the percentage of the fund's net asset value locked in for different periods of time as well as information about side pocket and gating arrangements. For purposes of determining whether a private fund is a qualifying hedge fund, the adviser would have to aggregate any parallel managed accounts, parallel funds, and funds that are part of the same master-feeder arrangement, and would have to treat any private funds managed by its related persons as if they were managed by the filing adviser.

Section 3 would mandate additional disclosures by private fund advisers that advise at least one "liquidity fund" and that manage at least US$1 billion in combined liquidity fund and registered money market fund assets. Section 3 would ask such advisers to disclose information about each liquidity fund that they manage, including: (a) valuation methodology for calculating net asset value; (b) whether the fund is managed in compliance with certain provisions of Rule 2a-7 under the Investment Company Act (which governs regulation of registered money market funds); (c) portfolio characteristics, including weighted average maturity and weighted average life of the portfolio; (d) fund borrowings, including a breakdown by creditor type and the maturity profile of such borrowings; and (e) investor concentration and liquidity as well as gating and redemption policies, and a good faith estimate of the percentage of the fund purchased using securities lending collateral.

Section 4 would mandate additional disclosures by advisers with private equity fund assets under management of at least US$1 billion. Section 4 would require information about each private equity fund they manage, including information about: (a) the fund's borrowings and guarantees; (b) leverage of portfolio companies, including debt to equity ratios, maturity profile of outstanding debt, and any events of default experienced by the fund or any portfolio companies; (c) the amount of bridge financing for portfolio companies as well as identification information for bridge financing providers; (d) identification of portfolio companies in the financial industry and the fund's beneficial ownership of such companies; and (e) the breakdown of the fund's investments by industry and geography.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys.

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