

CFTC and SEC Propose Private Fund Systemic Risk Reporting Rules

The Commodity Futures Trading Commission and Securities and Exchange Commission on January 26, 2011, jointly proposed new rules (collectively "Proposed Rules") under the Commodity Exchange Act ("CEA") and the Investment Advisers Act of 1940 ("Advisers Act") to implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") that require systemic risk reporting by registered investment advisers, commodity pool operators ("CPOs") and commodity trading advisors ("CTAs").¹ The Proposed Rules would require registered investment advisers to private funds, as well as CPOs and CTAs dually registered with the SEC and CFTC, to electronically file a new reporting form ("Form PF") with the SEC for use by the Financial Stability Oversight Council ("FSOC") in monitoring systemic risk to the U.S. financial system.² Form PF would require reporting of a wealth of information previously undisclosed to regulators relating to private funds, resulting in significantly

increased compliance costs for advisers, particularly private fund advisers deemed to be "large" who would have to file Form PF quarterly. Importantly, the information reported on Form PF would not be publicly available.

Background

The Dodd-Frank Act, signed into law by President Obama on July 21, 2010,³ established the FSOC with the mission of monitoring for, and responding to, systemic risks to the financial stability of the United States. The Dodd-Frank Act directs the FSOC to recommend to the Board of Governors of the Federal Reserve System ("Federal Reserve") heightened prudential standards for designated nonbank financial companies, so that the Federal Reserve may supervise such companies that may pose risks to U.S. financial stability in the event of their material financial distress or failure or because of their activities.⁴ In furtherance of this goal, the Dodd-Frank Act authorizes the SEC to require certain investment advisers to file reports on the "private funds" they advise, and these reports are to be shared with the FSOC to the extent it deems necessary in assessing the systemic risk posed by a private fund.⁵ The Dodd-Frank Act grants

¹ Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, SEC Release No. IA-3145 (Jan. 25, 2011) (joint proposed rules) (hereinafter "Proposing Release"), available at <http://www.sec.gov/rules/proposed/2011/ia-3145.pdf>.

² The CFTC has also issued notice of parallel proposed rules creating new forms (Form CPO-PQR for CPOs and Form CTA-PR for CTAs) requiring similar disclosures for CPOs and CTAs that are solely registered with the CFTC. See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 FR 7976 (Feb. 11, 2011) (hereinafter "Parallel Proposed Rules"), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister012611b.pdf>.

³ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴ Section 112 of the Dodd-Frank Act.

⁵ Section 404 of the Dodd-Frank Act.

the CFTC and SEC rulemaking authority to fulfill this mandate.⁶

Who Must File Form PF

Under the Proposed Rules, SEC-registered investment advisers that advise one or more “private funds” would be required to file Form PF.⁷ The requirement would not extend to “exempt reporting advisers” (i.e., advisers solely to venture capital funds or advisers solely to private funds that in the aggregate have less than \$150 million in assets under management (“AUM”) in the United States).

In addition, registered investment advisers that are also CPOs or CTAs registered with the CFTC, that advise one or more private funds must report on Form PF information about commodity pools that are “private funds.”⁸ By including this information on Form PF, such CPOs and CTAs would also satisfy a portion of their systemic risk reporting requirements under the CFTC’s Parallel Proposed Rules.⁹

The Proposed Rules would permit, but not require, an adviser to file one consolidated Form PF for itself and its “related persons.”¹⁰ For any private fund that is a sub-advised fund, only one adviser would report information on Form PF with respect to that fund. If an adviser completes information on Schedule D of Form

⁶ Section 406 of the Dodd-Frank Act.

⁷ Proposed Advisers Act rule 204(b)-1. Under the Advisers Act, as amended by the Dodd-Frank Act, a “private fund” is an issuer that is exempted from the definition of “investment company” under the Investment Company Act of 1940 (“1940 Act”) by Section 3(c)(1) or 3(c)(7) of the 1940 Act. Section 202(a)(29) of the Advisers Act. These exemptions are broad, and cover many U.S. or foreign investment funds sold to U.S. persons.

⁸ Proposed CEA rule 4.27(d).

⁹ Such CPOs and CTAs will be deemed to have satisfied their filing requirements for Schedules B and C of proposed Form CPO-PQR and Schedule B of proposed Form CTA-PR, respectively.

¹⁰ “Related persons” are defined generally as: (1) all of the adviser’s officers, partners, or directors (or any persons performing similar functions); (2) all persons directly or indirectly controlling, controlled by, or under common control with the adviser; and (3) all of the adviser’s employees (other than employees performing only clerical, administrative, support or similar functions).

ADV with respect to any private fund, the same adviser would be responsible for reporting on Form PF with respect to that fund.

Private Fund Advisers

The information proposed to be reported by private fund advisers, CPOs and CTAs (collectively “private fund advisers”) on Form PF would vary depending on the size and types of private funds advised. Under the Proposed Rules, every private fund adviser required to file Form PF would be required to complete Section 1, which requests information regarding any hedge funds advised, in addition to information about each private fund’s AUM, performance and use of leverage. For some private fund advisers, this is the only section that would need to be completed. However, “large private fund advisers” would be required to complete certain additional sections of Form PF. Under the Proposed Rules, there are three types of large private fund advisers:

- Advisers managing “hedge funds”¹¹ that collectively have at least \$1 billion in assets as of the close of business on any day during the reporting period (“large hedge fund advisers”);
- Advisers managing a “liquidity fund”¹² and having combined liquidity fund *and* registered money market fund assets of at least \$1 billion as of the close of business on any day during the

¹¹ Form PF would define a “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 (“NAV”) (including any committed capital) or may have gross notional exposure in excess of twice its NAV (including any committed capital); or (3) may sell securities or other assets short. This is the same definition that the SEC has proposed in its amendments to Form ADV. The Proposing Release provides that a fund should not net long and short positions in calculating its borrowings but should include any borrowings or notional exposure of another person, that are guaranteed by the fund or that the fund may otherwise be obligated to satisfy. This is a broad definition that covers many more investment funds than those commonly referred to as “hedge funds.”

¹² Form PF would define 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.

reporting period (“large liquidity fund advisers”); and

- Advisers managing “private equity funds”¹³ that collectively have at least \$1 billion in assets as of the close of business on the last day of the quarterly reporting period for the required report (“large private equity fund advisers”).

In order to avoid duplicative reporting, a commodity pool that meets the definition of a “private fund” would be treated as a hedge fund for purposes of Form PF, and CPOs and CTAs filing Form PF would be relieved of certain reporting requirements under the CFTC’s Parallel Proposed Rules.¹⁴

Calculation of AUM

In determining whether an adviser is a large private fund adviser for purposes of Form PF, the adviser would be required to aggregate:

- 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 the private fund (“parallel managed accounts”); and
- Assets of that type of private fund advised by any of the adviser’s “related persons” (which is a broad concept).

The \$1 billion thresholds would be based on gross assets rather than net assets. Therefore, an adviser with modest assets under management could become a

¹³ Form PF would define 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. A “real estate fund” would be 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. A “securitized asset fund” would be defined as any private fund that is not a hedge fund and that issues asset-backed securities and whose investors are primarily debt holders. A “venture capital fund” would have the same definition as in proposed rule 203(l)-1 under the Advisers Act.

¹⁴ Thus, CPOs and CTAs that meet the \$1 billion AUM threshold (“large commodity pool advisers”) would have the same reporting requirements as large hedge fund advisers.

large private fund adviser as a result of leverage. In addition, unlike Form ADV, Form PF would require advisers to include assets of parallel managed accounts that are not “securities portfolios” within the meaning of the instructions to Form ADV. For many private fund advisers, this means that the AUM reported on Form PF would differ from the adviser’s “Regulatory AUM” that would be reported on Form ADV, as it has been proposed to be amended.¹⁵ Accordingly, advisers reporting under \$1 billion in Regulatory AUM on Form ADV could cross the \$1 billion threshold for purposes of Form PF and be subject to more extensive and frequent reporting.

In calculating AUM, advisers would exclude assets in any account that are exclusively invested in other funds, such as a fund of funds.¹⁶ In addition, if the adviser’s principal office and place of business is outside the United States, the adviser could exclude any private fund that during the last fiscal year was neither a U.S. person nor offered to, or beneficially owned by, any U.S. person.

Conversely, a foreign adviser would be required to report in respect of any private fund that has at least one U.S. investor, regardless of the amount of the investment. In light of the broad definition of “private fund” and the difficulty to ensure that U.S. investors do not invest in foreign funds, foreign advisers may have to report with respect to many investment funds.

Information Required on Form PF

Section 1

All private fund advisers who must file Form PF would be required to complete Section 1. This Section asks for identifying information regarding the adviser and its related persons, aggregate information about the private funds managed by the adviser, including total and net assets, and the amount of those assets that are

¹⁵ Under the proposed amendments to Form ADV, “regulatory assets under management” would include only securities portfolios for which an adviser provides continuous and regular supervisory or management services, as of the date of filing the Form ADV. An account would be a “securities portfolio” if at least 50% of the total value of the account consisted of securities.

¹⁶ However, advisers should note that, for purposes of Form PF, a private fund is considered a “fund of funds” only if it invests solely in other private funds.

attributable to certain types of private funds. Private fund advisers must also enter into Section 1 information about *each* private fund they advise, including ownership, borrowing and performance data, as well as the aggregate notional value of its derivative positions. However, an adviser to private funds in a master-feeder arrangement would only have to report this information on an aggregate basis rather than reporting it for each feeder fund. Finally, Section 1 requests information with respect to any hedge funds advised by the private fund adviser, including:

- Investment strategies;
- Percentage of the fund's assets managed using computer-driven trading algorithms;
- Significant trading counterparty exposures;
- Identity of such counterparties, and
- Trading and clearing practices.

Section 2

Large hedge fund advisers and large commodity pool advisers would be required to complete Section 2, which requests a sweeping range of information. Due to the breadth, depth and frequency of the reporting required (see below), large hedge fund and commodity pool advisers will need to make data compilation and reporting with respect to Form PF an ongoing part of their operations. Section 2 requires such advisers to provide aggregate information about the exposure, through short and long positions, of the hedge funds and commodity pools¹⁷ they advise for each month of the reporting period (i.e., 3 months), including the duration of any fixed income portfolio holdings. The information must be broken down by asset class, including:

- Equity securities;
- Equity, credit and other derivatives;
- Commodities;
- Corporate bonds;
- Convertible bonds;

- Sovereign and municipal bonds;
- Loans; and
- Asset-backed securities and other structured products.

Form PF also seeks a geographic breakdown of the fund's investments.

In addition, Section 2 requires information about *each* "qualifying hedge fund" advised. A qualifying hedge fund is one with a NAV (individually or in combination with certain "parallel funds" or "accounts") of at least \$500 million as of the close of business on any day during the reporting period. In determining whether a private fund is a qualifying hedge fund, an adviser must aggregate any parallel managed accounts, parallel funds, and funds that are part of the same master-feeder structure, and would have to regard any private funds managed by its related persons as if they were managed by the adviser filing Form PF.

An adviser would have to provide the same exposure data for each qualifying hedge fund as that reported in the aggregate for all hedge funds it advises. In addition, for *each* qualifying hedge fund, the adviser must report information regarding:

- Portfolio liquidity;
- Concentration of positions;
- Collateral practices with significant counterparties;
- Clearing relationships with the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure;
- Risk metrics;
- Secured and unsecured borrowing and derivatives exposures;
- Value of the collateral and letters of credit supporting the secured borrowing and derivatives exposures;
- Types of creditors; and
- Investor composition and liquidity, including the fund's use of side pockets and gating arrangements.

¹⁷ Hereinafter, collectively "hedge funds."

Section 3

Large liquidity fund advisers would be required to complete Section 3. For *each* liquidity fund managed, advisers must report:

- Basic fund asset data for each month of the reporting period;
- The amount of assets invested in different types of instruments, broken down by the maturity of those instruments;
- Information for each open position of the fund that represents five percent or more of the fund's NAV;
- Information with respect to any secured and unsecured borrowing by the fund; and
- Information regarding the concentration of the fund's investor base, gating policies and investor liquidity.

Section 4

Large private equity fund advisers would be required to complete Section 4. For *each* private equity fund advised, Section 4 requires reporting with respect to:

- The outstanding balance of the fund's borrowings and guarantees;
- Data on the debt of controlled portfolio companies in which the fund invests; and
- Information on bridge financing.

Section 4 requests more specific information for any financial industry portfolio company that the private equity fund invests in. Finally, Section 4 seeks a breakdown of the fund's investments by industry and geography.

These proposed reporting requirements likely will require the use of new automated systems that could be costly to implement and monitor.

Temporary Hardship Exemption

Form PF would make available a temporary hardship exemption for private fund advisers who are unable to

file Form PF in a timely manner due to unanticipated financial difficulties. Private fund advisers may request a temporary hardship exemption by checking a box in Section 1 of Form PF and then completing Section 5.

Frequency of Reporting

All private fund advisers other than large private fund advisers would be required to file Form PF annually. For such smaller advisers, annual updates would be due by the last day on which the adviser may timely file its annual updating amendment to Form ADV (i.e., 90 days after the end of the adviser's fiscal year).

Under the Proposed Rules, large private fund advisers must file Form PF quarterly. Form PF would be due no later than 15 days after the end of each *calendar* quarter, which could be difficult to do based on current fund calendars. Large private fund advisers who are transitioning to become smaller private fund advisers must submit Form PF to report this change no later than the last day on which the adviser's next Form PF filing would be timely (i.e., 15 days after the calendar quarter-end). Similarly, private fund advisers who no longer meet the reporting requirements of Form PF must notify the SEC by filing Form PF no later than the last day on which the adviser's next Form PF filing would be timely. For all newly registering advisers, an initial Form PF filing would be submitted within 15 days of the end of the next occurring calendar quarter after registering with the SEC.

The SEC anticipates a compliance date of December 15, 2011, meaning that large private fund advisers would be required to make their initial Form PF filing by January 15, 2012, and smaller private fund advisers with a fiscal year ending December 31, 2011 would be required to file their first Form PF by March 31, 2012.

Confidentiality

The CFTC and SEC will share information collected on Form PF with the FSOC to the extent requested by the FSOC in furtherance of the FSOC's assessment of the systemic risk to the U.S. financial system posed by a private fund. The FSOC also may direct the Treasury Department's Office of Financial Research to collect information from a private fund adviser.¹⁸ Under

¹⁸ Sections 112 and 153 of the Dodd-Frank Act.

amendments to the Advisers Act added by the Dodd-Frank Act, the CFTC, SEC and FSOC may not be compelled to reveal any information provided on Form PF except under very limited circumstances.¹⁹ The CFTC and SEC, however, may use Form PF information in an enforcement action.

Each Form PF will be signed on behalf of the adviser and its related persons “under penalty of perjury.”

Conclusion

The requirements of proposed Form PF would impose significant new burdens on private fund advisers, particularly large private fund advisers who would face additional financial and time constraints. With an anticipated compliance date of December 15, 2011, private fund advisers may soon need to begin preparing their compliance personnel to develop the necessary systems to collect and report required information on Form PF.

The CFTC and SEC have requested comment on a broad range of issues relating to Form PF, and affected advisers may wish to consider submitting a comment letter. Advisers might pay particular attention to the requests for comment regarding: the appropriateness of the \$1 billion AUM thresholds and their manner of calculation; the definition of a “qualifying hedge fund”; whether certain information requested by Form PF is relevant in assessing a private fund’s systemic risk to the U.S. financial system; whether the frequency of reporting required by Form PF is necessary in assessing the systemic risk posed by a private fund; why certain information should not have to be reported; whether the compliance date provides enough time for advisers to prepare their compliance personnel with respect to development of systems to collect and report required information; and the meaning of signing the Form “under penalty of perjury.” Foreign advisers may also want to consider and comment upon the international coordination aspects of the proposal.” Comments are due by April 12, 2011.



¹⁹ The CFTC, SEC and FSOC may reveal information collected on Form PF only to Congress upon agreement of confidentiality, to another federal department or agency or self-regulatory organization upon proper request, or pursuant to a court order.

This update was authored by George J. Mazin (+1 212 698 3570; george.mazin@dechert.com), Robert H. Ledig (+1 202 261 3454; robert.ledig@dechert.com) and Jonathan Ohring (+1 212 698 3581; jonathan.ohring@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

If you would like to receive any of our other *DechertOnPoints*, please [click here](#).

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Julien Bourgeois
Washington, D.C.
+1 202 261 3451
julien.bourgeois@dechert.com

David L. Ansell
Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Kevin F. Cahill
Orange County
+1 949 442 6051
kevin.cahill@dechert.com

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Thomas C. Bogle
Washington, D.C.
+1 202 261 3360
thomas.bogle@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Christopher P. Harvey
Boston
+1 617 728 7167
christopher.harvey@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Richard M. Hervey
New York
+1 212 698 3568
richard.hervey@dechert.com

Richard Horowitz
New York
+1 212 698 3525
richard.horowitz@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

Matthew Kerfoot
New York
+1 212 641 5694
matthew.kerfoot@dechert.com

Robert H. Ledig
Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Reza Pishva
Washington, D.C.
+1 202 261 3459
reza.pishva@dechert.com

Edward L. Pittman
Washington, D.C.
+1 202 261 3387
edward.pittman@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Orange County
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Jeremy I. Senderowicz
New York
+1 212 641 5669
jeremy.senderowicz@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Michael L. Sherman
Washington, D.C.
+1 202 261 3449
michael.sherman@dechert.com

Stuart Strauss
New York
+1 212 698 3529
stuart.strauss@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

M. Holland West
New York
+1 212 698 3527
holland.west@dechert.com

Jennifer Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

U.S. Austin • Boston • Charlotte • Hartford • New York • Orange County • Philadelphia
Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels
Dublin • London • Luxembourg • Moscow • Munich • Paris • **ASIA** Beijing • Hong Kong