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## REGULATORY MONITOR

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### Securities and Exchange Commission Publishes Form PF Frequently Asked Questions

The Securities and Exchange Commission (SEC) publishes a list of responses by the Staff of the Division of Investment Management (Staff) to frequently asked questions (FAQs) that it has received regarding Form PF (the Form).<sup>1</sup> Among other issues, the FAQs address (i) how advisers should categorize private funds, (ii) how advisers should aggregate and disregard certain private funds and managed accounts, (iii) reporting of derivative transactions and counterparties, (iv) how an adviser should explain any assumptions the adviser used in completing the Form, and (v) certain definitional issues presented by the Form. This article addresses FAQs published on or before July 19, 2012.

### Background on Form PF

Form PF was adopted by the SEC and the Commodity Futures Trading Commission (CFTC) in Fall 2011. Certain investment advisers to private funds must periodically file

the Form with the SEC to provide information on the private funds they advise.<sup>2</sup> This information is reported on a confidential basis and intended to be used by the SEC to assist the Financial Stability Oversight Council (FSOC) in systemic risk monitoring. However, the SEC will also use the data reported on Form PF to inform other regulatory functions including examinations and investigations. The amount and type of information that an adviser must report depends on the size of the adviser and the type of funds managed.

Investment advisers must file Form PF if they are (i) registered or required to register with the SEC; (ii) advise one or more private funds; and (iii) have at least \$150 million in regulatory assets under management attributable to private funds as of the end of their most recently completed fiscal year.<sup>3</sup>

The Form PF Adopting Release incorporates the definition of “private fund” from Section 202(a)(29) of the Investment Company Act of 1940 (Investment Company Act): “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act.”<sup>4</sup> Non-US funds that are offered or sold to US persons or in the United States are generally considered private funds.<sup>5</sup>

All private fund advisers required to file Form PF must complete section 1 of Form PF. Section 1 requires advisers to provide information regarding the adviser’s identity and assets under management, limited information regarding the size, leverage and performance of all private funds subject to the reporting requirements, and

additional basic information regarding hedge funds. Advisers who are only required to file section 1 must file the form annually. Large Private Fund Advisers are required to file section 1 of Form PF, as well as additional sections:

- Large hedge fund advisers are advisers “having at least \$1.5 billion in regulatory assets under management attributable to hedge funds as of the end of any month in the prior fiscal quarter.”<sup>6</sup> Large hedge fund advisers must complete section 2 of Form PF.
- Large liquidity fund advisers are advisers “managing a liquidity fund and having at least \$1 billion in combined regulatory assets under management attributable to liquidity funds and registered money market funds as of the end of any month in the prior fiscal quarter.”<sup>7</sup> Large liquidity fund advisers must complete section 3 of Form PF.
- Large private equity fund advisers are advisers “having at least \$2 billion in regulatory assets under management attributable to private equity funds as of the last day of the adviser’s most recently completed fiscal year.”<sup>8</sup> Large private equity fund advisers must complete section 4 of Form PF.

Large hedge fund advisers and large liquidity fund advisers must update the information filed pursuant to Form PF pertaining to those funds (hedge funds and liquidity funds, respectively) quarterly. The information these advisers file with respect to the other funds they manage must be updated annually. Large private equity advisers must file Form PF annually and are not required to provide quarterly updates. The definition of the various fund types is technical and many funds will be considered hedge funds even though they would not generally be considered to be hedge funds for other purposes.

At the time of this column’s printing, large liquidity fund advisers will have made their first filing of Form PF on or before July 15, 2012.

## Form PF FAQs

Since Form PF was adopted, the Staff has invited questions on the Form and created a

dedicated email address for such questions.<sup>9</sup> While the Staff responds directly to inquiries, it has recognized that certain responses may benefit the industry as a whole and has posted, to date, public responses to FAQs on June 8, June 29, and July 19, 2012.

### A. *Categorizing Private Funds*

Many of the questions answered by the Staff related to how advisers should categorize the private funds they manage. The FAQs clarify that while other categories are mutually exclusive, two categories of funds are not mutually exclusive, noting that a private fund could be both a hedge fund and a liquidity fund for purposes of Form PF (by contrast, Form ADV only accepts one “type” for each private fund).<sup>10</sup> The FAQs explain that when a single private fund meets the criteria of both a hedge fund and a liquidity fund, the fund’s adviser must include the fund in its calculation of hedge fund assets under management and liquidity fund assets under management, and complete each section applicable to hedge funds and liquidity funds.<sup>11</sup>

The FAQs also discuss how a fund’s policies may affect the fund’s classification as a hedge fund, liquidity fund, or private equity fund. The FAQs state that an adviser must assess each private fund’s status for each reporting period and adjust the way that the fund is reported on Form PF accordingly as needed going forward. For an example, if a private fund that does not meet the definition of a hedge fund for one quarter because its policies do not permit (i) payment of a performance fee to its adviser based on unrealized gains, (ii) borrowing in excess of the specified amount, or (iii) short-selling, later changes its policies so that it does meet this definition, the adviser must begin reporting on the private fund as a hedge fund for the quarter immediately subsequent to the quarter in which the policies were changed.<sup>12</sup> According to the instructions to Form PF, an adviser is required to determine whether it has a quarterly hedge fund reporting obligation with respect to a private fund for a particular fiscal quarter by looking back at the preceding fiscal quarter and determining whether the private fund met the definition of a qualifying hedge fund on

the last day of each of the months of the prior fiscal quarter.

Similarly, the FAQs state that if a private fund's policies result in the private fund meeting the definition of a hedge fund, such as a policy permitting short-selling, the private fund must be categorized as a hedge fund for purposes of Form PF even if the fund does not intend to take the action permitted by the policy (that is, the private fund does not sell assets short and the adviser does not intend for the fund to engage in short selling at any time in the future).<sup>13</sup> As a result, some private equity funds or other private funds will fall within the technical definition of hedge fund for Form PF purposes. This can be avoided through an amendment to the fund's governing documents or other binding undertaking to investors not to short or borrow in a manner that would put the fund inside the definition of "hedge fund."

The FAQs also address the classification of private funds as commodity pools. Form PF specifies that any private fund that is also a commodity pool is categorized as a hedge fund for reporting purposes. Some advisers have noted that under CFTC interpretations, a private fund that holds a single commodity interest position may be a commodity pool. Because Form PF is a joint form by the SEC and CFTC, some advisers were concerned that the CFTC interpretation may govern reporting obligations for Form PF and require that private funds with *de minimis* commodity interest positions be reported as hedge funds. However, the FAQs clarify that if a private fund's commodity interest positions satisfy either of the *de minimis* tests in Regulation 4.13(a)(3)(ii) issued by the CFTC, and the fund does not otherwise meet the definition of a hedge fund, the private fund's adviser would not be required to categorize the private fund as a hedge fund.<sup>14</sup>

### ***B. Aggregating and Disregarding Funds***

The FAQs include a selection of questions from advisers on when to aggregate or disregard funds for purposes of determining their reporting requirements. One question addresses whether an adviser should aggregate parallel managed accounts advised by a related person that is not separately operated

when determining whether the parallel managed accounts are dependent parallel managed accounts. How such accounts are aggregated may affect whether the adviser triggers certain reporting thresholds. In the FAQs, the Staff clarifies that an adviser should determine its reporting requirements by initially attributing to itself any private funds and parallel managed accounts advised by a related person that is not separately operated. Then, the adviser may subtract from the total amount any aggregated parallel managed accounts that are not dependent parallel managed accounts as defined in the Form PF Glossary of Terms.<sup>15</sup>

The Staff stated that if a parallel managed account holds derivatives in its investment portfolio and the account value is reported to the account holder according to the market value of the derivatives, the adviser is not required to instead use the gross notional value of the derivatives for purposes of reporting on and/or aggregating the account on Form PF.<sup>16</sup>

The FAQs also address funds that can be disregarded in reporting on Form PF by advisers to funds of funds. The instructions to Form PF describe a disregarded private fund as one that invests substantially all of its assets in the equity of private funds *for which the filer is not the adviser*, and aside from such investments holds only cash, cash equivalents, and instruments acquired to hedge currency exposure. However, the FAQs clarify that equity in private funds *for which the filer is the adviser* is also a qualifying investment for a disregarded private fund.<sup>17</sup> Advisers that advise only disregarded private funds are required to file sections 1a and 1b of Form PF if the adviser and its related persons collectively manage at least \$150 million in private fund assets under management. However, advisers to private funds are not required to include disregarded private funds in determining whether they meet any of the large private fund adviser reporting thresholds or the \$5 billion compliance date thresholds.<sup>18</sup>

### ***C. Reporting on Derivative Transactions and Counterparties***

The Staff also answered questions regarding reporting on counterparties and derivatives

transactions. The Form PF FAQs clarify which securities to include in evaluating a fund's counterparty exposure<sup>19</sup> and provide guidance on how to evaluate a fund's counterparty exposure with respect to (i) securities lending, (ii) short transactions, (iii) repurchase agreements and reverse repurchase agreements, and (iv) non-cleared derivatives transactions with either an unrealized loss or an unrealized gain.<sup>20</sup> The FAQs state that for purposes of calculating an adviser's exposure to each counterparty, advisers should not net derivatives positions across different counterparties unless the counterparties are affiliated with one another and netting is permitted by instructions to the relevant Form PF question.<sup>21</sup> The FAQs also note that investors that are owed redemption proceeds are not credit counterparties for purposes of evaluating a fund's exposure to its counterparties. Where an adviser is required to report the value of all of a fund's derivatives positions, an adviser that has entered into several derivatives transactions with a single swap dealer may net across its positions with that dealer if doing so is consistent with the adviser's internal recordkeeping and risk management procedures, regardless of whether the adviser's ISDA agreement with the swap dealer allows netting. Whether an adviser should take into account margin in evaluating its exposure to a counterparty will change depending on which Form PF question the adviser is answering.<sup>22</sup>

#### ***D. Using Question 4 to Account for Advisers' Assumptions***

Many of the Form PF FAQs address technical questions from advisers on how to correctly fill out the Form. In these FAQs, the Staff generally indicates that where there are multiple reasonable ways to answer a single question on Form PF, an adviser may choose the method that is consistent with its internal methodologies and provide an explanation of any assumptions used in such answers in Question 4 of the Form.<sup>23</sup> For example, as discussed in the FAQs, although Mexico is geographically considered to be part of North America, some advisers treat the country as part of South America in their internal risk assessments. The FAQs state that when answering questions on

Form PF relating to the private funds' geographic exposure, such advisers may report on the funds' exposure to Mexican securities as exposure to South America and provide an explanatory note in Question 4.<sup>24</sup> Similarly, there are questions on the Form for which an adviser must exercise judgment. The FAQs state that for positions of a fund that could be accurately classified in multiple sub-asset classes identified in certain questions on the Form, an adviser should choose the sub-asset class that "describes the position with the highest degree of precision."<sup>25</sup>

Some advisers have filed, or taken substantial steps in preparation for filing Form PF in advance of the publication of an FAQ that announced a Staff position different from the adviser's reasonable assumptions. Question 4 can also be used to clarify advisers' assumptions that may change over time as advisers modify their systems to more closely align with SEC or Staff guidance regarding Form PF. One Form PF FAQ posted on July 19, 2012, addresses a hypothetical large liquidity fund adviser that filed Form PF on July 16, 2012, making certain assumptions that the adviser has noted are inconsistent with SEC guidance provided after July 16.<sup>26</sup> The FAQ indicates that the adviser is not required to amend its July 16 filing. Instead, the Staff recommends that the adviser's next filing of Form PF reflect the guidance and that the adviser "note in Question 4 any assumptions made in... [the] initial filing that were inconsistent with the Staff guidance." The Form PF FAQs state that an adviser cannot delay its filing of Form PF to calibrate its internal reporting systems to the Form.<sup>27</sup>

#### ***E. Definitions***

The FAQs also clarify the meaning of certain terms used in Form PF, including "borrowing." In addition to traditional lending activities such as secured and unsecured borrowings, the FAQs state that the value of a fund's borrowings should take into account "(i) selling securities short<sup>28</sup>, (ii) securities lending transactions, (iii) reverse repurchase agreements, (iv) transactions in which variation margin is owed, but as a result of not reaching a certain set threshold, has not been paid by a fund, or (v) transactions

involving synthetic borrowings.” Transactions involving synthetic borrowing would include total return swaps that meet the failed safe accounting requirements.<sup>29</sup>

Finally, the FAQs clarify the Form’s use of the terms gross notional exposure,<sup>30</sup> listed equity derivatives,<sup>31</sup> and net asset value<sup>32</sup> and provide mechanical information such as how to identify relying advisers or special purpose vehicles (SPVs) in reliance on the no-action letter issued to the American Bar Association.<sup>33</sup>

It can be expected that the Staff will post additional FAQs and responses after the Staff has reviewed initial Form PF filings by early filers. Investment advisers to private funds should continue to monitor the Form PF FAQ website for additional guidance.

## Notes

1. *Form PF Frequently Asked Questions* (Form PF FAQs), available at <http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml>. Initial FAQs were posted on June 8, 2012. This column discusses the complete set of FAQs as of July 19, 2012. Each FAQ indicates the date on which it was posted to the SEC’s website.

2. Form PF is a joint rule adopted by the SEC and CFTC. *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF*, Rel. No. IA-3308 (Oct. 1, 2011) (Form PF Adopting Release), available at <http://www.sec.gov/rules/final/2011/ia-3308.pdf>. The CFTC published its adopting release for Form PF on November 16, 2011.

3. Form PF Adopting Release, *supra* n.2 at 18. Regulatory assets under management must be calculated according to the instructions in Form ADV and are gross of outstanding indebtedness and other accrued but unpaid liabilities.

4. Section 3(c)(1) of the Investment Company Act provides an exclusion from the definition of “investment company” for any “issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” Section 3(c)(7) of the Investment Company Act provides an exclusion from the definition of “investment company” for any “issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” The term “qualified purchaser” is defined in section 2(a)(51) of the Investment Company Act. *Id.* at n.10.

5. *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers*, Release

No. IA-3222, 76 Fed. Reg. 39646, 39665 (June 22, 2011), available at [www.sec.gov/rules/final/2011/ia-3222.pdf](http://www.sec.gov/rules/final/2011/ia-3222.pdf).

6. Form PF Adopting Release, *supra* n.2 at 21.

7. *Id.*

8. *Id.*

9. FormPF@sec.gov.

10. Form PF FAQ C.1.

11. This will result in a disparity between the regulatory assets under management reported on PF and that which would be reported on ADV if calculated as of the same date.

12. Form PF FAQ B.2.

13. Form PF FAQ D.1.

14. Form PF FAQ B.1.

15. Form PF FAQ E.1.

16. Form PF FAQ 11.1.

17. Form PF FAQ F.1.

18. Form PF FAQ F.2.

19. Form PF FAQ 22.1.

20. Form PF FAQ 22.3.

21. Form PF FAQ 22.4.

22. Form PF FAQ 22.5.

23. Form PF FAQ 4.1.

24. Form PF FAQ 28.2

25. Form PF FAQ 26.6.

26. Form PF FAQ A.2.

27. Form PF FAQ A.3 states that if an adviser cannot incorporate Staff guidance in advance of an initial filing, the adviser should note in Question 4 how its filing is inconsistent with Staff guidance.

28. Form PF FAQ 12.2 states that a short transaction should be valued, for purposes of reporting on Form PF, in the same way the transaction is valued internally and to current and prospective investors of the fund that is selling the security short.

29. Form PF FAQ 12.1.

30. Form PF FAQ B.3 states that gross notional exposure is the same as gross notional value, a term defined in the Form PF Glossary of Terms.

31. Form PF FAQ 26.1 clarifies that “listed” refers to whether the underlying equity asset is a listed equity, not whether the derivative is listed.

32. Form PF defines a fund’s “net asset value” as the fund’s regulatory assets under management minus any outstanding indebtedness or other accrued but unpaid liabilities. Form PF FAQ G.1 allows advisers to report

on Form PF a net asset value that is calculated without deducting deferred compensation if such advisers do not deduct deferred compensation when calculating the net asset value to be reported to investors. The Form PF FAQ instructs such advisers to note in Question 4 that they are not deducting deferred compensation amounts when reporting net asset value of a fund.

33. Form PF FAQ A.1 states that the Private Fund Reporting Depository will be upgraded to allow advisers to add relying advisers or SPVs as related persons in Question 1(b) of Form PF, which requests this information. However, until the upgrade, advisers may identify such relying advisers or SPVs as related persons in Question 4.

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