Published on *The National Law Review* https://natlawreview.com

SEC Proposes Significant Amendments to Form PF

Article By:

Robert E Plaze

Corey A. Dietrich

On January 26, 2022, the U.S. Securities and Exchange Commission (the "SEC") proposed amendments to Form PF and related rules (the "Proposed Amendments") under the Investment Advisers Act of 1940 ("Advisers Act"). Form PF is the confidential reporting form used by certain advisers to private funds to report information to the SEC and the Financial Stability Oversight Counsel ("FSOC") about private funds. The SEC stated that the Proposed Amendments are designed to further improve the FSOC's capabilities to monitor systemic risk and to gather additional information for regulatory purposes, including enforcement, examinations and rulemaking.

The Proposed Amendments would significantly increase the reporting requirements for private fund advisers that currently file Form PF and expand the number of advisers to private equity funds required to complete Section 4. If adopted, the amended Form PF would:

- Require large hedge fund advisers and private equity advisers to file Section 5 and Section 6 reports, respectively, with the SEC within one business day of the occurrences of certain specified events;
- Lower the threshold for an adviser reporting as a large private equity adviser from $2 billion to $1.5 billion in private equity fund assets under management;
- Increase the amount of information reported by large private equity advisers under Section 4; and
- Expand reporting for large liquidity fund advisers.

These proposals were the first in what has been several SEC initiatives focused on the private funds market.[1]

Timing and Applicability

Comments on the Proposed Amendments are due on March 21, 2022. The Proposed Amendments do not contain any transition period for compliance, but presumably will apply to new Form PF filings after the expiration of a transition period identified in the SEC's adopting release. We surmise that this may be a reasonable period because the IARD system through which advisers file the form will require significant re-programming to accommodate the revised form, and we believe the SEC will understand that it will take some time for Form PF filers to adjust their systems to the new requirements.

Background

The SEC adopted Form PF in 2011 after enactment of the Dodd-Frank Act, which directed the SEC to collect information about private funds for use by the FSOC to help in its assessment of systemic risk in the financial system. Form PF is required to be filed by advisers to hedge funds, private equity funds and liquidity funds (*i.e.*, private money market funds).

Form PF requires all registered advisers with at least $150 million in "private fund assets under management" to report general information regarding each private fund, including its size, leverage, types of investors, concentration, liquidity, and performance within 120 days after their fiscal year-end (Section 1). The form's reporting obligations differ among different types of private funds:

- *Large hedge fund advisers*, those with at least $1.5 billion in hedge fund assets under management, must provide certain information about all hedge fund assets (Section 2a) and more granular financial information (Section 2b) about each Qualifying Hedge Fund (a hedge fund, individually or in combination with any feeder funds, parallel funds and/or dependent managed account, having a net asset value ("NAV") of at least $500 million). Reports must be made within 60 days after the end of each quarter.

- *Large private equity advisers*, those with at least $2 billion of private equity assets under management, must report more detailed, albeit different (from hedge funds), operational information (Section 4), and must report annually within 120 days after fiscal year-end.

- *Large liquidity fund advisers*, those with at least $1 billion in combined registered and unregistered money market fund assets, must provide certain information about their operations (Section 3). They must report within 15 days after the end of each quarter.

In the release proposing the amendments to Form PF (the "Proposing Release"), the SEC and FSOC observed that since 2011, assets of private funds reported on a Form PF have grown considerably, from $5 trillion in 2013 to $11 trillion at the end of 2020. Based on that growth and their experience over the past 11 years, including the market volatility occurring in March 2020, the SEC and FSOC assert that they need both more data and more current data to monitor systemic and other risks.

Overview

Current Event Reporting

The Proposed Amendments would require an adviser to file reports as to certain events within **one business day** of the occurrence of any of such events, which would be the close of the business day following the event. The Proposing Release explains that the information the SEC and FSOC currently receive from the Form PF is stale and is often submitted months after the occurrence of an event that may have systemic significance.

The current event reporting requirements would be set forth in new Sections 5 (Qualifying Hedge Funds) and 6 (all private equity funds) of Form PF. Each section would provide advisers with the ability to provide a narrative explanation of their responses if they believe additional information would be useful. An adviser would file a current report as a stand-alone document, allowing advisers to avoid re-filing an entirely new Form PF.

Large Hedge Fund Advisers

To address certain perceived deficiencies in current Form PF, the Proposed Rule would add a new Section 5 to Form PF, which would require large hedge fund advisers to file a new report **within one business day** of the occurrence of nine triggering events by a Qualifying Hedge Fund:

- *Extraordinary Investment Losses.* A cumulative loss of 20% or more in a Qualifying Hedge Fund's NAV based upon the fund's most recently reported NAV figures (*e.*, the NAV reported on the last filed Form PF) over a rolling 10 business day period. A single day loss of 20% would also have to be reported, as well as cumulating losses (net of any daily gains) over the 10-day period. The report would require disclosure of the beginning and end dates of the loss period and the dollar amount of such losses over the loss period.

- *Significant Margin and Default Events.* Any of the following three types of margin events:

    - A Qualifying Hedge Fund experiences a cumulative increase in margin, collateral, or an equivalent of more than 20% of the fund's most recent reported NAV figures over a rolling 10 business day period, even if the increase occurs as a result of a new business line, new prime brokerage relationships or regulatory changes. The report would require disclosure of the beginning and end dates involved, the cumulative dollar amount of the increase, the identities of the counterparties requiring the increase, and the identification of any of six applicable specified reasons (including "other") for the increase.

    - A Qualifying Hedge Fund's margin default or its inability to meet a margin call (after the expiration of any applicable cure period, unless the fund would not expect to be able to meet the call during such cure period). A report would not be required to be filed, however, if there is a dispute regarding the amount and appropriateness of the margin call so long as the fund has sufficient assets to meet the greatest of the disputed amount. The report would include the date of the notification of margin default or determination, the dollar amount of the margin, collateral or equivalent involved, the identity of the counterparty, and the identification of any of four applicable specified circumstances (including "other") for the default or determination.

    - A margin default by a Qualifying Hedge Fund's counterparty where the counterparty (regardless of whether the counterparty is a broker-dealer or bank) (i) does not meet a call for margin, collateral or equivalent or fails to make other payments, in the time and form contractually required (taking into account any contractually agreed cure period), and (ii) the amount involved is greater than 5% of the most recent reported NAV figures of the fund. The report would disclose the date of the default, the dollar amount of default and the name of the counterparty defaulting. Reasons for the counterparty default would not be required.

- *Material Change to a Prime Broker Relationship*. A material change to a Qualifying Hedge Fund's prime broker relationship, including (i) imposition of material trading limits or investment restrictions on the fund (including requests to reduce or unwind positions), and (ii) termination of the prime brokerage arrangement. The report would include the date of the material change, the name of the prime broker and the identification of the adviser's current understanding of the change in the prime broker relationship and, if applicable, which party terminated the relationship.

- *Decline in Unencumbered Cash.* A decline in a Qualifying Hedge Fund's unencumbered cash (as defined in Form PF Glossary of Terms) by more than 20% of the fund's most recent reported NAV figures over a rolling 10 business day period. The report would identify the last day of the 10-day period and the identification of any of five specified reasons (including "other") for the decline.

- *Operational Disruptions.* A significant disruption or degradation of a Qualifying Hedge Fund's "key operations", whether as a result of an event at a service provider to the fund or the adviser, necessary for (i) investment, trading, valuation, reporting and risk management functions of the fund, or (ii) the operation of the fund in accordance with the Federal securities laws and regulations. The Proposing Release states that "[w]hen evaluating a …fund's key operations that are reasonably measurable, a 'significant disruption or degradation' means a 20% disruption or degradation of normal volume or capacity". The SEC gave, as examples, a cybersecurity event and a severe weather event causing a power outage. The report would identify the estimated date the event first occurred, the date the event was discovered and the adviser's current understanding of any of six possible causes of the event (including "other").

- *Significant Redemptions*. Cumulative requests for redemptions exceeding 50% (it is unclear whether the correct measurement is "exceeding 50%" or "equal to or more than 50%" as the Proposing Release and text of the form requiring the disclosure states the former and the introduction in the section of the form states the latter) of a Qualifying Hedge Fund's most recent reported NAV figures (after netting subscriptions and other contributions from investors, either received or contractually committed, but not taking into account gates at the fund and/or investor level or other fund terms designed to address significant redemptions). The report would identify the date on which redemptions requests "exceed" 50%, the net value of redemptions paid between the last filed Form PF and the date of the current report and the percentage of the fund's most recent reported NAV figures for which redemptions have been requested. The report also requires the adviser to indicate whether the investors in the fund have been notified that the fund will liquidate.

- *Inability to Satisfy Redemption*. A Qualifying Hedge Fund is: (i) unable to pay redemption requests; or (ii) suspends redemption requests for more than five consecutive business days. The report would disclose (a) the date on which the fund was unable to pay redemption requests or suspends redemptions, (b) the percentage of the fund's most recent reported NAV figures for which redemptions have been requested and not yet paid, and (c) whether the investors had been notified that the fund will liquidate.

Key Open Question(s) to Consider

- Many Qualifying Hedge Funds have Level 2 and 3 assets, which are valued quarterly (or possibly monthly). It is unclear how advisers could produce reports within one business day that would be accurate.

- A number of the items will likely require Large Hedge Fund Advisers to file reports of events at Qualifying Hedge Funds that do not implicate market stress (*e.g.*, an increase in margin because of a change in investment strategy or addition of new prime broker). Should the SEC, therefore, narrow the reporting requirements when it adopts the amendments to eliminate the number of "false positives" that will clog the data the SEC and FSOC receive and reduce reporting burdens on advisers?

- Unlike mutual funds, hedge funds successfully employ gates and other mechanisms to mitigate the adverse impact on fund portfolios of heavy redemptions and thus systemic risks they may present. Accordingly, one could question what purpose is served in requiring Qualifying Hedge Funds that employ such mechanisms to report notices of large redemptions requests that may, for example, be deferred over a number of redemption windows.

Private Equity Funds

The Proposed Amendments would add a new Section 6 to Form PF, which would require advisers to private equity funds to file current reports **within one business day** of the occurrence of one or more of the three reporting events described below. The section must be filed by private equity fund advisers that have at least $150 million of private equity fund assets under management.

Like Section 5, a private equity fund adviser may provide a narrative explanation of its responses, and would only file a current report as a stand-alone document rather than re-filing its entire Form PF. Unlike Section 5, the SEC and FSOC's purpose here does not appear to be limited to gathering information for analysis of systemic risk, but focuses on certain regulatory concerns regarding transactions involving potential conflicts of interest. Thus, a current report by a private equity fund adviser may, if the amendments are adopted as proposed, prompt an SEC examination.

The three situations where a private equity adviser would be required to file a Form 6 within one business of the event occurring are:

- *Adviser-Led Secondary Transactions.* Advisers would be required to report the completion of an "adviser-led secondary transaction." An "adviser-led secondary transaction" would be defined as any transaction initiated by the adviser or any of its related persons that offers private equity investors the choice to (i) sell all or a portion of their interests in the private fund, or (ii) convert or exchange all or a portion of their interests in the private fund into an interest in another vehicle advised by the adviser or any of its related persons (typically referred to as a "continuation fund"). Unsolicited requests made by an investor to the adviser to participate in a secondary transaction would be excluded from this reporting. The report would require disclosure of the completion date of the transaction and a description of the transaction.

- *General Partner or Limited Partner Clawback.* Advisers would be required to report upon implementation of a general partner clawback, which the SEC would define as any obligation of the general partner to return performance compensation to a fund under its governing agreements. A limited partner clawback would be defined as an obligation of the limited partners to return some or all of the distributions made by the fund to the limited partners that are in excess of 10% of the fund's aggregate capital commitments. The report would require disclosure of the effective date of the clawback, the type of clawback (general partner/limited partner) and the reason for the clawback. The SEC explained that it believed such clawbacks, if reported by multiple private funds, could indicate systemic stress.

- *General Partner Removal, Termination of the Investment Period or Termination of a Fund.* Advisers would be required to report when a fund receives notification that fund investors have (i) removed the adviser or an affiliate as the general partner (or similar control person) of the fund; (ii) elected to terminate the fund's investment period, or (iii) elected to terminate the fund, in each case as contemplated by the fund's governing documents. The report would disclose the effective date and description of the event.

Reduction in Large Private Equity Adviser Reporting Threshold

The SEC also proposed to lower the reporting threshold for large private equity advisers from $2 billion to $1.5 billion in private equity fund assets. The SEC explained that a threshold of $1.5 billion would result in the same proportion of private equity fund assets being reported (75%) today as when Form PF was first issued in 2011, and thus provide the SEC and FSOC with a data set of equivalent usefulness to monitor the private fund industry.

Large Private Equity Adviser Reporting

The SEC proposed a number of changes to the existing section of Form PF that requires Large Private Equity Advisers to private equity funds to identify other information about the private equity funds they manage (Section 4) on an annual basis. Among the proposed changes are:

- *Private Equity Fund Strategies (new Question 68).* The Proposed Amendments would require advisers to identify the investment strategies pursued by the fund from a list of 14 strategies commonly employed by private equity funds (*e.g.*, buyout, secondaries, real estate). If the fund engages in multiple strategies, the advisers would be required to provide a good faith estimate of the percentage of the fund's deployed capital represented by each. This new information is designed to give the SEC and FSOC a sense of how private equity capital is used and to allow for a more informed analysis of the Form PF data (*e.g*., the SEC could screen for events affecting one segment of the private equity industry).

- *Restructurings and Recapitalizations of Portfolio Companies (new Question 70).* Advisers would be required to identify any portfolio company that was restructured or recapitalized after the end of the fund's investment period, and the date of the restructuring. Although not clear from the Proposing Release, the new item is designed to provide regulators with information about the market environment in which private funds operate, for systemic as well as compliance purposes.

- *Investments in Different Levels of Capital Structure (new Question 71).* Adviser would be required to report whether funds advised by the adviser or related persons are invested in different levels of a portfolio company's capital structure. More specifically, the adviser would report whether the reporting fund held an investment in one class, series or type of securities (*e.g.,* debt, equity, etc.) of a portfolio company while another fund advised by the same adviser or related person concurrently holds an investment in that portfolio company through a different class or series of securities. The Proposing Release explains that this reporting requirement is designed to be used by SEC compliance examiners to identify significant conflicts of interests.

- *Fund and Portfolio Company Level Borrowing (new Questions 72 and 74).* The Proposed Amendments would require advisers to disclose information about borrowing at the fund level and whether the fund or any related person has provided financing at the portfolio company level.
    - If such borrowing is permitted at the fund level, an adviser would be required to disclose (i) information on each borrowing or other cash financing available to the fund, (ii) the total dollar amount available for such borrowing, and (iii) the average amount borrowed by the fund over the reporting period.
    - Advisers would also be required to report whether they or any of their related persons provide financing or other extensions of credit to their portfolio companies.
- *Events of Default and Geographic Breakdown of Fund Investments.(amends several Questions)* The Proposed Amendments would require advisers to provide more granular information concerning (i) the nature of reported events of default under the applicable borrowing agreement (such as whether such default is that of the fund, a connected counter party, or a default relating to a failure to uphold terms (other than payment)), and (ii) a geographical breakdown of investments by a fund, which will identify the fund's greatest country exposures based on percent of NAV.

Large Liquidity Fund Advisers Reporting

The Proposed Amendments would significantly revise and expand the reporting requirements for large liquidity fund advisers to mirror the reports money market funds must file through Form N-MFP, which the SEC has recently proposed to amend. The proposed revisions will adapt the form's data requirements to categories of data the Federal Reserve Board uses in its internal reports and analysis, and are designed to provide FSOC (primarily the Fed) with a more complete picture of the short-term financing markets and in doing so, improve their ability to facilitate oversight of those markets and their participants.

Looking Ahead

The Proposed Amendments, if adopted, would significantly expand the reporting requirements of advisers to hedge funds, private equity funds, and liquidity funds. In addition to presenting fundamental questions of regulatory mission creep, the Proposed Amendments raise numerous technical issues. These will undoubtedly be the subject of many comments received after a very brief comment period. Those comments will be critical to illuminating all of these issues and providing the SEC and FSOC help to both improve the quality of data they receive and minimize the burdens on the industry.

Perhaps the most troublesome and challenging aspects of the Proposed Amendments is the proposed one business day reporting requirement for current reports. This aspect of rulemaking seems unrealistic, particularly as it applies to certain of the items applicable to hedge funds (*e.g.*, extraordinary losses), which often may hold securities that are not valued on a daily basis. In the case of private equity funds, it seems unnecessary as those questions seem primarily designed for regulatory purposes, and regulators do not have the time or resources to address compliance issues on a real-time basis.

FOOTNOTES

[1] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews,* Adviser Act Rel. No 5955 (Feb. 9, 2022); *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies*, Advisers Act Rel. No. 5956 (Feb. 9, 2022). *See also* SEC Division of Examinations Risk Alert: Observations from Examinations of Private Fund Advisers (June 23, 2020)

National Law Review, Volume XII, Number 70