Davis Polk

Private Equity Regulatory Update - August 2022

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In this issue, we discuss proposed amendments to Form PF by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

SEC proposes amendments to Form PF to monitor systemic risk and bolster the SEC's regulatory oversight of private fund advisers

Summary

In an August 10, 2022 release (Proposing Release), the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) concurrently proposed amendments (Proposal) to Form PF. The SEC also proposed amendments to Rule 204(b)-1 under the Investment Advisers Act to revise instructions for requesting a temporary hardship exemption.

The Proposal is designed to assist the SEC in identifying trends in the private funds industry that could create systemic risk, improve data quality and comparability, and reduce reporting errors by providing greater insight into the operations and strategies of private funds. Some key takeaways of the Proposal include:

- A more prescriptive approach for reporting complex fund structures (e.g., reporting separately each component fund of a master-feeder arrangement and parallel fund structure).
- Updated reporting timelines such that large hedge fund advisers and large liquidity fund advisers must update Form PF within a certain number of days after the end of each calendar quarter, instead of at the end of each fiscal quarter.

Background

In 2011, the SEC and CFTC adopted Form PF, which an adviser to private funds, including those that also are registered with the CFTC as a commodity pool operator or commodity trading adviser, must file if: (1) it is registered or required to register with the SEC as an investment adviser, (2) it manages one or more private funds, and (3) the adviser and its related persons collectively had at least $150 million in private fund assets under management as of the last day of its most recently completed fiscal year. The SEC and the Financial Stability Oversight Council (FSOC) use Form PF to gather confidential information regarding the operations and strategies of private funds in order to monitor and assess systemic risk and can use the information gathered in examinations, investigations, and investor protection efforts and other regulatory programs.

Proposed amendments

The Proposal would enhance reporting to provide greater insight into private funds' operations and strategies and would require additional information about advisers and the private funds they manage, including more detailed information regarding hedge fund investment strategies, counterparty exposures, and trading and clearing mechanisms. The Proposal would also implement the following changes, among other things:

Amend how advisers report complex structures

Under the existing Form PF advisers can report complex fund structures in the aggregate or separately so long as their reporting is consistent. The SEC view is that the current practice can obscure risk profiles and make comparing complex structures difficult. Under the Proposal, advisers generally would report each component fund, like master-feeder arrangements and parallel fund structures, separately, except where a feeder fund invests all its assets in a single master fund and/or "cash and cash equivalents." Under the Proposal, advisers would continue to aggregate structures to determine if they continue to meet a reporting threshold.

Enhance reporting for hedge funds

Section 1C of Form PF requires advisers to provide information on the hedge funds they advise. The proposal would require advisers to report additional information regarding operations and strategies. Instead of the current approach which allows advisers the flexibility to report a fund's strategy as of the data reporting date or throughout the reporting period, advisers would have to report an investment strategy that best describes the fund's strategies on the last day of the reporting period under the Proposal. The SEC's determination is that this approach would improve the quality of the data it receives by establishing a consistent format for reporting how a fund's strategy changes over time. In addition, the SEC intends to include more granular categories for equity and credit strategies. The proposal would add categories such as real estate and digital assets, which have become more commonly pursued by hedge funds since the adoption of Form PF. In connection with this change the SEC proposes to define "digital asset" "as an asset that is issued and/or transferred using distributed ledger or blockchain technology ("distributed ledger technology"), including, but not limited to, so-called "virtual currencies," "coins," and "tokens."" By obtaining information that is more granular the SEC's view is that it can conduct more targeted analysis and improve comparability among advisers and hedge funds. Moreover, in the SEC's view, these changes would allow the SEC to improve its ability to identify investor protection issues during periods of stress.

Update reporting timelines

The SEC view is that the current reporting timelines, which allow large hedge fund and large liquidity fund advisers to update their Form PF after the end of the fiscal quarter, significantly delay the SEC from receiving a full data set for a calendar quarter. For example, currently, as noted in the Proposal, a large hedge fund adviser whose fiscal quarter ends at the end of March would file data for the first calendar quarter at the end of May, whereas a large hedge fund adviser whose fiscal quarter ends in May would not file its March data until the end of July. Under the Proposal, large fund advisers would be required to update Form PF a certain number of days (e.g., 60 days for large hedge fund advisers and 15 days for large liquidity fund advisers) after the end of each calendar quarter, as opposed to their fiscal quarter. Other advisers would continue to file annual updates within 120 calendar days after the end of their fiscal year. The proposed changes are intended to provide a more complete data set sooner and to improve the efficiency and effectiveness of investor protection efforts and systemic risk assessment.

Remove aggregate reporting for large hedge fund advisers

The Proposal would also remove the requirement for large hedge fund advisers to report certain aggregated information about the hedge funds they advise. The SEC noted that aggregation can lead to inconsistencies between data reported on an aggregate basis in section 2a and on a per fund basis in section 2b. In addition, the SEC believes that aggregated reporting for funds with different strategies and activities can mask directional exposure of individual funds.

The SEC has requested public comments on the Proposal, to be received by the SEC on or before October 11, 2022.