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ALERT MEMORANDUM

SEC Imposes Significant New Reporting on Advisers in Proposed Amendments to Form PF

January 31, 2022

On January 26, 2022 the U.S. Securities and Exchange Commission ("SEC") adopted proposed amendments to Form PF that would dramatically expand both the frequency and amount of reporting by private fund advisers and hedge fund advisers (the "Proposal"). The Proposal is purportedly intended as part of an effort to bolster the Financial Stability Oversight Counsel's ("FSOC") ability to monitor systemic risk. However the breadth of the new reporting requirements goes well beyond this stated objective and captures smaller investment advisers and routine investment activity that appear purely to foster the SEC's more general objectives – data collection to support examinations, investigations and investor protection efforts relating to exempt reporting advisers. Indeed, many of the new reporting requirements align to recent risk alerts and statements about proposed rulemaking from the staff and SEC Chair Gensler. If adopted, these amendments will facilitate more aggressive action by the Enforcement Division as well as the Division of Examinations.

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Most notably, the Proposal would introduce a "current reporting" requirement that would require registered investment advisers to report certain events within one business day of occurrence. For private equity fund advisers, those events would include: general partner or limited partner clawbacks, adviser-led secondary transactions, removal of a fund's general partner, termination of a fund's investment period and termination of a fund. Current reporting events for large hedge fund advisers would include substantial declines in a fund's net asset value or unencumbered cash, certain margin events, material changes in prime broker relationships and significant impairments of fund operations.

Below is a brief summary of our key takeaways and notable points from the Proposal (available here), along with specific interpretive issues that the industry will want to consider during the comment period. The comment period will remain open for 30 days after the Proposal's publication in the Federal Register – also aggressive given that the SEC typically provides 45 or 60 days for review and comment.

Current Reporting

Under the existing rules, private equity advisers file Form PF annually and large hedge fund advisers file quarterly. The Proposal establishes a list of triggers that would require private equity fund advisers and large hedge fund advisers to submit a current report to the SEC within one business day. Current reporting for private equity fund advisers focuses on a small subset of transactions such as clawbacks and investor directed fund terminations that, according to the SEC, indicate a fund is potentially in distress. Because such transactions generally require minimum notice periods, the one business day reporting requirement for private equity fund advisers may not be as onerous as the requirements imposed on hedge funds. The hedge fund reporting requirements focus on market-influenced changes in a fund's portfolio and balance sheet, such as significant losses and fluctuations in margin requirements, which are more obvious signs of systemic risk. However, such triggers can occur concurrent with market volatility that can be sudden, and undertaking to identify, quantify and report such occurrences in a single business day, for large funds operating across multiple jurisdictions, is expected to be burdensome for advisers to both implement and monitor.

In both instances, the one business day timing is a significant departure from similar reporting regimes, such as the four business day reporting period for Form 8-K and the "prompt" reporting of arguably more significant changes relating to an adviser and its funds for certain amendments to Form ADV, which is generally interpreted to mean at least 30 days.

The Proposal also suggests that such current reports may be subject to a requirement to update, in contrast to current rules for Form PF, which is generally only updated annually, and Form ADV, which is only updated other than annually for a limited specified set of material changes. While the SEC has assumed such current reports would be rare, and therefore updates to such reports even rarer, for advisers with those events compiling and monitoring for necessary updates can pose a significant administrative burden.

<u>Current reports by private fund advisers would be required for the following transactions</u>:

— ***Execution of an adviser-led secondary transaction***. The Proposal defines an adviser-led secondary transaction as any transaction initiated by the adviser or a related person that offers investors the choice to: (1) sell all or a portion of their interests in the private fund or (2) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or a related person. The SEC stated that these transactions present conflicts of interests that merit timely reporting and monitoring. They also posit that these transactions indicate an inability to sell portfolio companies and could be a leading indicator of a declining market. In our experience, however, adviser-led secondary transactions are fairly common, and are used by many established and well regarded sponsors as a way to provide investors with the option for liquidity while still allowing those investors that wish to do so the opportunity to retain an interest in the underlying investment(s), including well performing assets. Such transactions have also not historically been tied to larger systemic risk. While it is true that conflicts of interest arise in these types of transactions, conflicts can be mitigated through thoughtful process, disclosure and, where necessary, investor or advisory board consent to the transaction. We note these similar conflicts arise when an adviser buys portfolio companies from a fund directly in a principal transaction, which is not subject to reporting and which is deemed to be 'cured' of the conflict by obtaining consent.

— ***General partner or limited partner clawback***. The Proposal defines a general partner clawback as any obligation of the general partner, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the fund pursuant to the fund's governing agreements. Reporting would be required at the time the general partner returns the compensation to the fund. The Proposal would also require reporting a limited partner clawback in excess of 10% of a reporting fund's aggregate capital commitments.

The SEC argues that the implementation of general partner and limited partner clawbacks by private equity fund advisers is typically rare, and that if many funds are implementing general partner clawbacks at the same time, it could be indicative of the early stages of a distressed credit environment.

— ***Removal of a fund's general partner, termination of a fund's investment period, or termination of a fund***. A current report would be required when a fund receives notification that investors have: (1) removed the adviser or an affiliate as the general partner or similar control person of a fund, (2) elected to terminate the fund's investment period, or (3) elected to terminate the fund, in each case as contemplated by the fund documents. The SEC acknowledges that these events are rare, but believes they could provide an indication of market deterioration and also raise investor protection issues, including potential conflicts of interest. Changes in a fund adviser or general partner and fund terminations, when directed by an adviser, are only subject to annual reporting on Form ADV.

<u>Current reports by large hedge fund advisers would be required upon the following triggers</u>:

— ***Extraordinary investment losses***. Under the Proposal a large hedge fund experiencing "extraordinary losses" within a short period of time would be required to provide a current report describing the losses. This reporting would be triggered by a loss equal to or greater than 20% of a fund's most recent net asset value over a rolling 10 business day period.

Notably, investment losses triggering the reporting requirement could also include unrealized losses, i.e. losses relating to fluctuations in market values instead of actual trading activity. The difficulty in quantifying such losses, particularly during times of marketing volatility, would likely result in the one business day reporting deadline creating an operational burden. Such losses may also be more rightly characterized as evidence of a short-term tumultuous market, rather than being indicative of widespread systemic risk.

— ***Significant margin increases and defaults***. A current report would be required if a large hedge fund experiences a cumulative increase in margin of more than 20% of the fund's most recent net asset value over a rolling 10 business day period (which may presumably be spread across multiple counterparties, particularly given the prevalence of cross-defaults in margin facilities). Advisers would not be required to file a current report in situations where there is a dispute in the amount and appropriateness of a margin call, as long as the fund has sufficient assets to meet the maximum disputed amount.

— Additionally, a current report would be required if a fund counterparty does not meet a margin call or fails to make any other payment, and the amount involved is greater than 5% of the fund's most recent net asset value.

— ***Significant decline in holdings of unencumbered cash***. A current report would be required if the value of the reporting hedge fund's unencumbered cash declines by more than 20% of the fund's most recent net asset value over a rolling 10 business day period.

— ***Material changes in relationships with prime brokers***. A current report would be required by material changes to a fund's ability to trade with a prime broker or an outright termination of the prime brokerage relationship for default or breach of the prime brokerage agreement.

— ***"Significant disruption or degradation" of the reporting fund's "key operations."*** A current report would be required if a hedge fund adviser or a reporting hedge fund experiences a "significant disruption or degradation" of the fund's "key operations," whether as a result of an event at the fund, the adviser, or other service provider to the fund. Examples of such events provided by the

SEC include severe weather events, power outages, and disruptions at service providers that would inhibit asset valuations.

Expanded Annual Reporting

— ***The Proposal would expand the number of advisers who would have to report as "Large Private Fund Advisers" by lowering the threshold from $2 billion AUM to $1.5 billion AUM.*** The SEC stated that lowering this threshold would enable the SEC and FSOC to receive reporting from a similar proportion of the U.S. private equity industry based on committed capital as they did when Form PF was initially adopted, noting that in 2011, the $2 billion reporting threshold captured 75% of the U.S. private equity industry based on committed capital. Today, this threshold only captures about 67% of the U.S. private equity industry.

— ***These "Large Private Fund Advisers" would be required to report additional information relating to fund strategies, use of leverage and portfolio companies***. In addition, the SEC has solicited comment on whether certain additional data fields should also be required of *all* reporting advisers, or the threshold should be moved lower (to $500 million). These additional data fields include:

- Investment strategies and percent of deployed capital to each of those strategies. While many of the categories seem non-contentious (such as Mid-Market Lending and Senior Debt), allocating a complex portfolio among such broad categories may be burdensome. Other investment categories, such as "digital assets" seem targeted at information gathering for the SEC's increased focus on regulating cryptocurrencies. Notably, the SEC's January 27, 2022 "Risk Alert – Observations from Examinations of Private Fund Advisers" (available here) made note of advisers who implement an investment strategy that diverges materially from fund disclosures. Advisers should ensure that their disclosures are consistent with the information being reported on Form PF.

- Portfolio company and controlled portfolio company ("CPC") reporting. The Proposal focuses extensively on the relationship of advisers to portfolio companies and CPCs, and would require reporting of (1) how many CPCs each reporting fund owns, (2) whether the adviser or any related person provides financing or otherwise extend credit to any portfolio company in which the fund invests, and the value of the financing or extension of credit, (3) the percentage of the aggregate borrowings of a fund's CPCs that are at a floating rate rather than a fixed rate, (4) details of portfolio company and CPC restructurings or recapitalizations following the fund's investment period, (5) investments in different levels of a single portfolio company's capital structure by funds advised by an adviser or a related person and (6) the identity of the institutions providing bridge financing to the adviser's CPCs and the amount of such financing. This final item would require additional counterparty identifying information and if the counterparty is affiliated with a major financial institution, the name of the financial institution.

- Again, while the links to systemic risk of the proposed portfolio company reporting fields is tenuous, many of the items can be traced to concerns raised by the SEC in examination risk alerts and speeches, such as the SEC's June 23, 2020 "Risk Alert – Observations from Examinations of Investment Advisors Managing Private Funds" (available here) which noted private fund advisers failing to provide adequate disclosure about conflicts created by causing funds to invest at different levels of a portfolio company's capital structure. Compliance procedures to ensure that an adviser's disclosures—specifically their conflicts disclosures—accurately reflect the portfolio company arrangements to be reported on Form PF will be critical.

- Fund level reporting. In addition to the focus on portfolio companies, the Proposal would add reporting relating to financing arrangements and significant corporate events at the fund level. Specifically, advisers would report for each reporting fund (1) whether the fund borrows or has the ability to borrow at the fund level as an alternative or complement to the financing of portfolio companies, (2) more granular information about the nature of reported events of default, such as whether it is a payment default of the fund, a payment default of a CPC, or a default relating to a failure to uphold terms under the applicable borrowing agreement (other than a failure to make regularly scheduled payments).
- Expanded reporting of the geographical breakdown of investments by private equity fund advisers. The Proposal moves away from reporting based on a static group of regions and countries and towards identifying a private equity fund's greatest country exposures based a percent of net asset value. The Proposal would require these advisers to report all countries to which a reporting fund has exposure of 10% or more of its net asset value. As a systemic risk measure, this expanded reporting is intended to identify concentrations of investments in countries that could be experiencing instability or a natural disaster. It also has the collateral effect of allowing the SEC to more effectively measure exposure to politically sensitive regions.
- ***The Proposal would require large liquidity fund advisers to report substantially the same information that registered money market funds report on Form N-MFP***. The Proposal would revise how large liquidity fund advisers report operational information and assets, as well as portfolio, financing, and investor information.

Conclusion

The proposed amendments to Form PF have generated strong reactions within the industry, and we expect the comment period to be active. We are working with industry groups to gather and provide comments, and if you have any points you would like us to consider in our commentary, please reach out. The SEC is also currently working on additional proposed rulemaking with respect to private equity advisers that is scheduled for April 2022. Even if specific proposed additional reporting items do not ultimately get adopted in the revised Form PF, the breadth of the Proposal provides valuable insights into the SEC's continuing examination and enforcement focus areas, and advisers should review both their internal data tracking and their disclosures in light of the topics covered by the Proposal.

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