

January 31, 2011

SEC Proposes Private Fund Systemic Risk Reporting Rule and Rule Amendments Relating to the Definition of Accredited Investor under Dodd-Frank

I. Private Fund Systemic Risk Reporting

On January 25, 2011, the U.S. Securities and Exchange Commission (the "SEC") proposed new Rule 204(b)-1 (the "Proposed Rule")¹ under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").² The Proposed Rule would require SEC-registered investment advisers that advise one or more "private funds"³ to file a new reporting form with the SEC, Form PF, which would require the reporting of, among other

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

² The Proposing Release was issued jointly by the SEC and the Commodity Futures Trading Commission (the "CFTC"). The CFTC proposed new Rule 4.27(d) under the Commodity Exchange Act, as amended, which would require commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") registered with the CFTC to satisfy certain proposed CFTC filing requirements by filing Form PF with the SEC, but only if those CPOs and CTAs are also registered with the SEC as investment advisers and advise one or more private funds. Because commodity pools that meet the definition of a private fund are categorized as hedge funds for purposes of Form PF, CPOs and CTAs filing Form PF would need to complete only the sections applicable to hedge fund advisers, and the form would be a joint form only with respect to those sections. With respect to CPOs and CTAs that are not dual registrants, the CFTC proposed Forms CPO-PQR and CTA-PR to capture substantively identical information as Form PF, with appropriate modifications. The CFTC also voted to propose rules that will rescind or modify several of its commonly-used registration exemptions and exclusions, including the exemptions from CPO registration under regulations 4.13(a)(3) and (4). This memorandum does not specifically address the proposed reporting requirements applicable to CPOs and CTAs.

³ A "private fund" is any issuer that would be an investment company as defined in Section 3 of the Investment Company Act of 1940, as amended, but for Sections 3(c)(1) or 3(c)(7) of that Act. A "private fund adviser" is any investment adviser that is: (i) registered or required to register with the SEC (including any investment adviser that is also registered or required to register with the CFTC as a CPO or CTA) and (ii) advises one or more private funds.

things, performance-related information, counterparty exposure and borrowings. The information contained in Form PF is designed primarily to assist the Financial Stability Oversight Council (the "FSOC") in assessing systemic risk in the U.S. financial system; however, the information would also be available to assist the SEC in its regulatory programs, including examinations, investigations, enforcement actions and investor protection efforts relating to private fund advisers. The information would be reported electronically on Form PF and would remain confidential except in very limited circumstances, as discussed below.

Comments on the Proposed Rule are due within 60 days after its publication in the Federal Register (the estimated due date is March 28, 2011).

A. Reporting Requirements

Section 404 of the Dodd-Frank Act, which amends Section 204(b) of the Advisers Act, directs the SEC to require private fund advisers to maintain records and file reports containing such information as the SEC deems necessary and appropriate in the public interest and for investor protection or for the assessment of systemic risk by the FSOC. The records and reports must include certain information about private funds, such as the amount of assets under management, use of leverage, counterparty credit risk exposure, and trading and investment positions for each private fund advised by the private fund adviser. Form PF is designed to fulfill this statutory mandate.

Under the Proposed Rule, the amount and type of information reported, as well as the frequency of reporting, would vary based on both the size of the private fund adviser and the type(s) of private funds it advises. In general, small private fund advisers would be required to complete only Section 1 of Form PF by providing information about their private fund assets under management and their funds' performance and use of leverage, as well as certain information regarding any hedge funds⁴ they advise. Certain large private fund advisers would be required to complete additional sections of Form PF, which require more detailed information, the focus of which varies depending on the type of private fund that the adviser manages. "Large Private Fund Advisers" would include any private fund adviser with \$1 billion or more in hedge fund, "liquidity fund" (i.e., unregistered money market fund)⁵ or private

⁴ A "hedge fund" is any private fund that: (i) has a performance fee or allocation calculated by taking into account unrealized gains; (ii) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (iii) may sell securities or other assets short. For purposes of this definition, a private fund adviser should not net long and short positions. In addition, a private fund adviser should include any borrowings or notional exposure of another person that are guaranteed by the private fund or that the private fund may otherwise be obligated to satisfy. Solely for purposes of Form PF, a commodity pool satisfying the definition of "private fund" is categorized as a hedge fund.

⁵ This memorandum does not address the proposed reporting requirements applicable to private fund advisers of liquidity funds.

equity fund⁶ assets under management.⁷ These assets under management thresholds should be measured daily for hedge funds and liquidity funds and quarterly for private equity funds. All other private fund advisers would be regarded as small private fund advisers. Large Private Fund Advisers would be required to file Form PF on a quarterly basis, while small private fund advisers would be required to file Form PF on an annual basis.

The following chart summarizes by type of private fund adviser the sections to be completed on Form PF, key information to be reported and frequency of reporting.

Adviser Type	Form PF Section	Key Information to be Provided	Frequency of Reporting	Initial Filing Date
Private Fund Adviser	1a, 1b	<ul style="list-style-type: none"> ➤ identifying information ➤ information regarding related persons ➤ regulatory and net AUM ➤ regulatory and net AUM by types of funds ➤ aggregate notional value of derivative positions by fund ➤ borrowings information by fund (dollar amount, percentage from U.S. and non-U.S. financial institutions, names of large creditors) ➤ monthly net and gross performance information by fund 	annually within 90 days of fiscal year end	March 31, 2012

⁶ A “private equity fund” is any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and that does not provide investors with redemption rights in the ordinary course.

⁷ Section 1 would require the private fund adviser to indicate the adviser’s total “regulatory assets under management,” using the same proposed definition of that term as used on proposed amendments to Part 1 of Form ADV (see SEC Release No. IA-3110 entitled “Rules Implementing Amendments to the Investment Advisers Act of 1940” at <http://www.sec.gov/rules/proposed/2010/ia-3110.pdf>). For purposes of determining whether a private fund adviser is a Large Private Fund Adviser, each adviser would have to aggregate together: (i) assets of managed accounts advised by the adviser that pursue substantially the same investment objective and strategy and invest in substantially the same positions as the private fund (“parallel managed accounts”); and (ii) assets of that type of private fund advised by any of the adviser’s related persons. The private fund adviser would be required to exclude any assets in any account that are solely invested in other funds (i.e., internal or external fund of funds) in order to avoid duplicative reporting.

Adviser Type	Form PF Section	Key Information to be Provided	Frequency of Reporting	Initial Filing Date
Private Fund Adviser Advising Hedge Funds	1a, 1b, 1c	Same as above, plus: <ul style="list-style-type: none"> ➤ identification of investment strategy ➤ percentage of fund's assets attributable to computer-driven algorithms ➤ five trading counterparties to which hedge fund has greatest exposure ➤ information regarding trading and clearing mechanics 	annually within 90 days of fiscal year end	March 31, 2012
Large Private Fund Adviser with Hedge Fund AUM in Excess of \$1bn	1a, 1b, 1c, 2a, 2b	Same as above, plus: <ul style="list-style-type: none"> ➤ monthly breakdown of aggregate exposure to each instrument type (different types of equities, fixed income securities, derivatives and structured products) ➤ turnover rate ➤ geographical breakdown of investments for each qualifying hedge fund ⁸ ("QHF"): <ul style="list-style-type: none"> ➤ monthly breakdown of exposure to each instrument type ➤ percentage of portfolio capable of liquidation with defined time frames ➤ amount of cash reserves ➤ total number of open positions ➤ information on each position exceeding 5% of QHF's NAV ➤ information on top five trading counterparties ➤ risk metrics information (VaR) ➤ effect of market factors on QHF 	quarterly within 15 calendar days of calendar quarter end	January 15, 2012

⁸ A "qualifying hedge fund" is any "hedge fund" that has a net asset value individually, or in combination with any parallel funds and/or parallel managed accounts, of at least \$500 million as of the close of business on any day during the most recently completed calendar quarter.

Adviser Type	Form PF Section	Key Information to be Provided	Frequency of Reporting	Initial Filing Date
		<ul style="list-style-type: none"> ➤ financing information ➤ value of derivative positions ➤ financing liquidity information ➤ information on side-pockets and withdrawal restrictions ➤ breakdown of investor liquidity 		
Large Private Fund Adviser with Private Equity Fund AUM in Excess of \$1bn	1a, 1b, 4	<p>Same as private fund adviser, plus for each private equity fund:</p> <ul style="list-style-type: none"> ➤ value of borrowing facilities and guarantees ➤ weighted average debt-to-equity ratio of any controlled portfolio company ➤ highest and lowest debt-to-equity ratio of any controlled portfolio company ➤ breakdown of indebtedness of controlled portfolio companies by maturity ➤ percentage of aggregate indebtedness of controlled portfolio companies attributable to payment-in-kind or zero-coupon debt ➤ incidence of events of default ➤ identification of bridge loans ➤ investments in financial industry portfolio companies ➤ breakdown of investments by industry ➤ geographical breakdown of investments 	quarterly within 15 calendar days of calendar quarter end	January 15, 2012

Importantly, if the private fund 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. This aspect of the proposed form is designed to allow a private fund adviser to report with respect to only those private funds that are more likely to implicate U.S. regulatory interests.

B. Confidentiality

The SEC is precluded from being compelled to reveal information reported on Form PF, except in very limited circumstances. Specifically, Section 404 of the Dodd-Frank Act states that the SEC shall make available to the FSOC copies of all reports, documents, records and information filed with or provided to the SEC by a private fund adviser under Section 404 of the Dodd-Frank Act as the FSOC may consider necessary for the purpose of assessing the systemic risk posed by a private fund and that the FSOC shall maintain the confidentiality of that information consistent with the level of confidentiality established for the SEC in Section 404 of the Dodd-Frank Act. In addition, Section 404 of the Dodd-Frank Act states that the SEC “may not be compelled to disclose any report or information contained therein required to be filed with the Commission under [Section 404],” except that the SEC must, upon request, disclose the information to: (i) Congress upon an agreement of confidentiality; (ii) another federal department or agency or any self-regulatory organization requesting the report or information for purposes within the scope of its jurisdiction (which is required to keep the information confidential to the same extent as the SEC); or (iii) comply with an order of a court of the United States in an action brought by the United States or the SEC. Section 404 further provides that information reported on Form PF will be exempt from requests for information under the Freedom of Information Act (“FOIA”) and will be protected from disclosure in non-FOIA litigation.

C. Exempt Reporting Advisers

The Dodd-Frank Act created exemptions from SEC registration under the Advisers Act for investment advisers solely to venture capital funds and for investment advisers solely to private funds that in the aggregate have less than \$150 million in assets under management in the United States (such investment advisers, “Exempt Reporting Advisers”).⁹ Under the Proposed Rule, Exempt Reporting Advisers would not be required to file Form PF.

II. Net Worth Standard for Accredited Investors

On January 25, 2011, the SEC also proposed amendments to the “accredited investor” standards set forth in the rules under the Securities Act of 1933, as amended (the “Securities Act”), to reflect the requirements of Section 413(a) of the Dodd-Frank Act. These standards delineate investors to whom issuers may sell securities in specified private and other limited offerings without registration under the Securities Act. Section 413(a) of the Dodd-Frank Act requires the definition of “accredited investor” to exclude the value of a person’s primary residence for purposes of determining whether a natural person qualifies as an “accredited investor” on the basis of having an individual net worth (or joint net worth with the spouse of that person) in excess of \$1 million.

⁹ Note, however, that the SEC has proposed that such Exempt Reporting Advisers will be required to report certain information about their advisory businesses, as well as the private funds they advise, on Part 1 of Form ADV (see SEC Release No. IA-3111 entitled “Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers” at <http://www.sec.gov/rules/proposed/2010/ia-3111.pdf>).

The proposed amendments clarify that “the value of the primary residence” — which must be excluded from the individual net worth calculation — is determined by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property. The new net worth standard must remain in effect until July 21, 2014, four years after enactment of the Dodd-Frank Act. Beginning in 2014, the SEC is required to review the definition of the term “accredited investor” in its entirety every four years and engage in further rulemaking to the extent it deems appropriate. The SEC also proposed technical amendments to Form D and a number of other rules to conform them to the language of Section 413(a). Comments on the proposed rule amendments are due by March 11, 2011.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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