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SEC Releases Frequently Asked Questions Regarding Form PF

On June 8, 2012, the Securities and Exchange Commission (the “SEC”) released Frequently Asked Questions (“FAQs”) regarding Form PF,¹ the private fund systemic risk reporting form promulgated by the SEC and the Commodity Futures Trading Commission (the “CFTC”).² The FAQs provide welcome clarity on several aspects of Form PF, including the treatment of hedge funds, liquidity funds, private equity funds, aggregation and fund of funds. The full text of the SEC’s FAQs is available at <http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml>. In addition, the SEC has requested that any further questions on Form PF be emailed to FormPF@sec.gov for potential inclusion in future updates to the FAQ.

The FAQs released by the SEC are summarized below, along with our comments regarding their impact:

I. Hedge Funds

Question 1.1: Form PF specifies that a commodity pool is categorized as a hedge fund for reporting purposes. However, CFTC interpretations provide that a fund with even a *de minimis* amount of commodity interests could be considered a commodity pool. The SEC clarified that a private fund should not be categorized as a commodity pool for purposes of the hedge fund definition if the private fund’s commodity interest positions satisfy either of the *de minimis* tests in Regulation 4.13(a)(3)(ii) issued by the CFTC. Prior to the release of the FAQs, many advisers were unsure of the proper way to treat a private fund that holds a *de minimis* amount of commodity interests but otherwise does not satisfy the hedge fund definition (e.g., a private equity fund that engages in a minimal amount of commodity interest activity). Through the FAQs, the SEC clarified that such a fund does not have to be reported as a hedge fund merely because of a *de minimis* amount of commodity interest positions.

Question 1.2: A hedge fund generally is defined to be any private fund that has the ability to pay a performance fee or allocation to its adviser, borrow in excess of a specified amount, or sell assets short. The SEC confirmed that the categorization of a private fund as a hedge fund may change from reporting period to reporting period if it previously did not meet this definition but later does so (due to, for example, amendments to the fund documentation). Therefore, advisers should review their private funds on at least a quarterly basis to ensure that their Form PF categorizations remain accurate.

II. Liquidity Funds

Question 2.1: Since the definitions of liquidity fund and hedge fund in Form PF are not mutually exclusive, the SEC confirmed that certain funds may meet both definitions and therefore should be reported under both categories. If the adviser to such a

1 See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Act Release No. 3308 (Oct. 31, 2011) (the “Release”), available at <http://www.sec.gov/rules/final/2011/ia-3308.pdf>.

2 For a summary of Form PF, see our prior mailing entitled “Form PF: Final Rules Adopted by the SEC and the CFTC” available at http://skadden.com/newsletters/Form_PF_Final_Rules_Adopted_by_the_SEC_and_the_CFTC.pdf.

fund is both a large hedge fund adviser and a large liquidity fund adviser, the adviser would report such fund in Sections 1, 2 and 3 of Form PF and would be required to report on such fund within 15 days after the quarter end (as a liquidity fund) and again within 60 days after the quarter end (as a hedge fund).

III. Private Equity Funds

Question 3.1: The SEC confirmed that the three-prong definition of hedge fund focuses on the fund's potential use of leverage or short selling, rather than its actual or contemplated use. Even if a fund does not in fact, nor does it intend to, incur leverage or short any assets, it may be considered a hedge fund for reporting purposes.

The SEC provides further guidance on this approach in the Release.³ In the Release, the SEC rejected commenters' arguments that a private fund should not be a hedge fund if it has the capacity to borrow or incur derivative exposures in excess of the specified amounts or to engage in short selling but does not in fact engage, or intend to engage, in such practices. However, the SEC confirmed in the Release that a private fund would not be a hedge fund solely because its organizational documents fail to prohibit the fund from engaging in such practices, so long as the fund in fact does not engage in such practices and a reasonable investor would understand, based on the fund's offering documents, that the fund will not engage in such practices.

IV. Aggregation

Question 4.1: Instruction 5 of Form PF requires an adviser to aggregate parallel funds, dependent parallel managed accounts, and master-feeder arrangements it advises to determine whether the adviser meets the various reporting thresholds of the Form. The adviser also is required to treat any private fund or parallel managed account advised by its related persons as though it were advised by the adviser, unless the related person is separately operated. The SEC confirmed that an adviser would include parallel managed accounts advised by a related person that is not separately operated when determining whether parallel managed accounts are dependent parallel managed accounts. The SEC includes several examples in this FAQ to illustrate the proper aggregation of a parallel managed account.

V. Fund of Funds

Question 5.1: Instruction 7 of Form PF limits the "fund of funds" definition to a private fund that invests substantially all of its assets in "external funds" and aside from such investments, holds only cash and cash equivalents and instruments acquired for the purpose of hedging currency exposure. Notwithstanding this instruction in the Form, the FAQ confirms the SEC's view that a fund of funds for purposes of Form PF may invest in both "external funds" and "internal funds" (that is, funds for which the filer is the adviser). Advisers to such funds only would be required to complete Section 1b of Form PF with respect to a fund of funds that meets the definition above.

Question 5.2: Instruction 7 of Form PF also specifies that a filer may disregard (i) certain private funds and (ii) a private fund's equity investment in other private funds when reporting on Form PF. The FAQ clarifies that an adviser must still report on Form PF even if the adviser advises only such disregarded funds and the adviser meets the \$150 million threshold of private fund assets under management. Such an adviser only would be required to complete Sections 1a and 1b of Form PF.

3 See Release at 28.