



Corgentum – 2012 Legal and Compliance Focus

At the SEC meeting on June 22, 2011, the SEC made its' adoption of rules final. This set of rules are intended to bring about the revision of the old regulatory framework in order to comply with the new requirements of 2010's Dodd-Frank legislation. The actual implementation of the lofty goals of Dodd-Frank has presented a number of challenges to regulators, fund managers and investors alike. For investors performing operational due diligence, in order to effectively diagnose the quality and competency of a fund manager's compliance with these new laws, and therefore the quality of the fund compliance function, it is important that they develop an understanding of the actual changes in the law. Furthermore, investors must also take measures to understand the way in which fund managers will be required to change their compliance and reporting practices to comply with these new laws. First let us consider the ways in which fund managers, such as hedge funds and private equity funds, will be required to adapt.

New Registration and Disclosure Requirements

The formal adoption of Dodd-Frank rules by the SEC marked the implementation of two major changes. First, the SEC effectively mandated required SEC registration for the bulk of hedge funds, private equity funds and other so-called "private" fund advisors which can also include 3(c)1 and 3(c)7 funds.

Previously, a number of exemptions were in place by which funds' managers could dodge registration requirements including Section 203(b)(3) of the Advisers Act. While under the new post Dodd-Frank regime, three primary exemptions still exist (the venture capital exemption, the private fund adviser with less than \$150 million under management, and the foreign private adviser exemption). These exemptions are much more narrowly constructed, and therefore harder to take advantage of for fund managers, than the previous broader exemptions. It is also worth noting that even these more narrowly construed exemptions do not give smaller fund managers (i.e. - with less than \$150 million under management) a free pass. The SEC has decided to shift the burden of regulating these smaller managers to the individual states in which they reside. Some fund managers may even be required to register with both the SEC and state regulators.

Long story short - most fund managers (i.e. - hedge funds, private equity or otherwise) who had previously been unregistered, will be required to register with the SEC at a minimum. This registration is required by March 30, 2012 for most managers and in a Valentine's Day gift from the SEC revised Form, ADV are required to be filed no later than February 14, 2012.

Form PF - A Complex Disclosure Web

The second major change is an increase in the amount and types of disclosures these funds will have to make. On October 26, 2011, the SEC unanimously approved the collection of information from fund managers such as hedge funds and private equity funds, for use by the Financial Stability Oversight Council to assist in monitoring the American financial system. In addition to changes in the types of information a fund manager is required to report in the revised Form ADV, the SEC has implemented a new additional disclosure requirement that certain fund managers may have to complete called Form PF.

Within the alternative investment community, these increased disclosures requirements were one of the most contentious and hotly debated proposed rule changes. Regardless of the merits of arguments in favor and against such disclosures, these debates are effectively moot as the Form PF requirements are now the law. Perhaps throwing the fund manager lobbying efforts a bone, the SEC has effectively acknowledged that the information disclosed in Form PF is more sensitive than that required in a Form ADV disclosure. As such, the SEC has stated that it does not intend to make the information reported in Form PF public. In typical SEC fashion however, these best of intentions are of course subject to a number of standard caveats, perhaps the most deadly of which for a hedge fund would be the reserved right of the SEC to utilize information reported on Form PF in enforcement actions.

Turning to Form PF itself, as with most regulatory matters, it is a bit complicated. For starters there are different rules, based on a number of different factors, as to which fund managers are actually required to file Form PF. Some fund managers are not required to fill out this additional form. There are three general requirements which need to be in place for a fund to have to file Form PF. They are:

- the fund manager manages at least \$150 million in so-called "private funds"
- the fund manager is, or is now required, to be registered
- the fund manager currently advises at least one private fund

Once a fund manager determines that they actually need to fill out Form PF this is where the real fun begins. Form PF requests information regarding a number of different items including size, leverage, types of investors and fund performance. The amount of information collected varies by fund manager, size and type.

In total, Form PF has five basic sections. The first section (i.e. - Section 1) applies to all fund managers that are required to file Form PF. To further complicate matters, in actually completing Section 1, as well as the other sections, there are a number of additional guidelines which the fund manager is advised to follow. One example would be funds that are organized in a master-feeder structure, which, according to guidelines, would be files together as opposed to separate Form PF's for each vehicle.

Beyond Section 1 is where the universality of the form stops. The other sections of Form PF are required to be filled out based on the fund type and assets under management.

New Operational Due Diligence Concerns

Section 2 of Form PF for example applies to hedge fund managers with at least \$1 billion in AUM, while Section 4 applies to private equity fund managers with at least \$1 billion in AUM. Section 3 applies to what are known as large liquidity fund advisors. There is also Section 5 which may contain a so-called hardship exemption. However, the specifics of Section 5 are still a bit of a mystery.

Additionally, there is a complex web of guidelines explaining when the first Form PF should actually be filed. These rules vary the filing time based on a number of factors including the types of funds managed, as well as the assets under management of the fund manager. Further complicating the issue are more rules related to how and when total assets under management of the fund manager should be calculated. Most larger fund managers (i.e. - larger than \$1 billion AUM) will be required to comply with Form PF by June 15, 2012 and will file their first Form PFs sometime during the third quarter of 2012. Smaller fund managers (i.e. - less than \$1 billion AUM) will be required to comply with Form PF by December 15, 2012, and will file their first Form PF sometime during the second quarter of 2013.

These initial filing rules interplay with yet even more rules which effect on-going filing frequency. After the filing of the first Form PF, some fund managers may be required to file Form PF more frequently (i.e. - quarterly) as compared to smaller fund managers (i.e. - annually). Furthermore, it is unclear how Form PF will actually be filed. The SEC has discussed perhaps allowing for electronic filing of Form PF, perhaps as part of the existing IARD system, but no specific solution has been finalized.

The Investor's Perspective - Adapting the Operational Due Diligence Process for Success

With all of these new laws and regulatory rules, some of which seem to still be in flux and with the actual implementation of such rules yet to be pinned down in actual practice by regulators, investors need to adapt their operational due diligence process accordingly. Some key questions investors should ask when first considering how to retool their operational due diligence program for 2012 should include:

- Has the fund manager performed an internal evaluation of whether or not they will be required to register with the SEC or any state authorities?
- If the fund manager is required to register with the SEC, have they evaluated if they will be required to complete Form PF?
- What steps has the fund manager taken to ensure that they understand the new Form PF reporting and disclosure requirements?
- Has the fund manager engaged appropriate legal counsel or compliance consultants to assist with this effort?
- If the fund manager's internal compliance function is going to lead the Form PF completion method, what have they done to ensure that they have the appropriate internal competencies to complete this?

Beyond Assessing Initial Compliance

Putting the specifics aside for a moment, a key point that investors should consider from an operational risk assessment perspective is whether or not their fund manager is being proactive in regards to ensuring compliance with these new regulations and reporting requirements. Such considerations are particularly important in light of increased enforcement actions by the SEC against funds that have either made misstatements in their filings or which have ignored SEC guidance regarding the rectification of former deficiencies.

Such considerations are particularly important in the context of an operational due diligence review due to the on-going filing requirements of Form PF. This marks an increasingly high-touch approach by the SEC towards requiring and monitoring fund disclosures. Such an approach is in stark contrast to the old paradigm where a fund manager may not have updated their Form ADV with much frequency or been in much contact at all with the SEC for a period of years at all.

In conclusion, when performing an operational due diligence review of a fund manager, be it a hedge fund, private equity fund or a traditional fund, investors should evaluate not only whether a fund is in compliance with the basic requirements of the new compliance guidelines. These should include not only SEC registration, additional ADV disclosure and initially filing Form PF, but also with ongoing requirements as well.

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