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October 11, 2022

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Via Electronic Filing

Re: Joint Proposed Rules: Amendments to Form PF to Amend Reporting Requirements for All Filers and Large Hedge Fund Advisers, Release No. IA-6083; File No. S7-22-22

Dear Ms. Countryman:

Ropes & Gray LLP appreciates the opportunity to provide these comments to the Securities and Exchange Commission (the "Commission") on the above-referenced matters.

Our firm represents the interests of many asset management firms that are registered with the Commission as investment advisers, including a wide range and significant number of investment management, hedge and private equity firms. The Proposing Release[1] addresses reporting on Form PF with respect to certain *private funds*,[2] which the Commission has stated are designed to enhance the Financial Stability Oversight Council's ("FSOC") ability to monitor systemic risk as well as to bolster its regulatory oversight of *private fund* advisers and investor protection efforts. In addition to its proposed changes to Form PF, the Commission has also noted that it is considering alternative definitions of the term *hedge fund*. We support these considered amendments in part and also believe that further modifications would be beneficial and supportive of the Commission's goals. We are therefore writing to provide our views on alternatives to the definition of the term *hedge fund* as described in the Proposing Release. The comments expressed herein reflect the views of the undersigned as practitioners with years of experience providing legal counsel to a wide variety of asset management firms. These comments and opinions are not intended to represent the views of our clients.

1. Changes to the Definition of *Hedge Fund* Are Warranted

As Form PF is currently drafted, it defines a *hedge fund*, in relevant part, as any *private fund* (other than a securitized asset fund) that (i) may be paid 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 or may have gross notional exposure in excess of twice its net asset value; or (iii) may

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[1] *See* Proposed Rules for Form PF; Reporting Requirements for All Filers and Larger Hedge Fund Advisers, 87 Fed. Reg. 53832 (proposed Sept. 01, 2022) (to be codified at 17 C.F.R. Pts. 275, 279) (the "Proposing Release").

[2] Italicized terms used herein have the definitions set forth in Form PF.

sell securities or other assets short or enter into similar transactions.[3] The Commission clarified in the adopting release of Form PF,[4] and again in its related FAQs,[5] that it rejects arguments that "the leverage and shorting characteristics in the definition of 'hedge fund' should focus on actual or contemplated use, rather than potential use."[6]

We believe the definition of *hedge fund* is overbroad. In our experience, as the Proposing Release acknowledges,[7] many *private funds* are caught by the definition of *hedge fund* that are not considered in the market to be hedge funds and do not in practice give rise to the kinds of potential risk that hedge fund reporting on Form PF is intended to illuminate. For example, private equity funds (private equity, private credit, infrastructure, real estate, etc.),[8] often have the ability to short sell in their limited partnership agreements, but do not engage in any short selling other than in extraordinary circumstances, and are nonetheless required to report on Form PF as *hedge funds*.[9] Moreover, although it is uncommon for a private equity fund to borrow an amount in excess of one-half of its net asset value, often the limited partnership agreements of private equity funds permit them to do so in order to allow for flexibility in managing drawdowns of capital commitments or other fund liquidity needs. This overbreadth has real consequences, in that *private funds,* despite being held out as pursuing a private equity-related strategy, are often misclassified as *hedge funds* and are required to report on practices and metrics that are often irrelevant for them and that are much more relevant for funds that the market would recognize as hedge funds (typically open-end funds that invest in publicly-traded equities, public credit, etc.), leading to a negative impact on data quality. As an example, Section 2 of Form PF requires *hedge funds* to report positions in listed equity, listed-equity derivatives and commodities, three types of assets that tend not to be a significant, if any, part of a private equity fund's portfolio, resulting in many

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[3] *See* Form PF: Glossary of Terms at pg. 4.

[4] *See* Adopting release for Form PF, "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF." 76 Fed. Reg. 71127 (Nov. 16, 2011) (the "Adopting Release") at 71134 "Changes to the "hedge fund" definition in response to these comments have not been made because clauses (b) and (c) properly focus on a fund's ability to engage in these practices. Even a fund for which leverage or short selling is an important part of its strategy may not engage in that practice during every reporting period. Thus, the suggested approach could result in incomplete data sets for hedge funds, a class of funds that may be systemically significant."

[5] *See* Form PF Frequently Asked Questions: **Q.D.1:** I advise a private fund that would be categorized as a private equity fund, except for the fact that the fund documents allow the fund to either employ large amounts of leverage or sell assets short. The fund does not in fact, nor does it intend to, incur leverage or short any assets. May I treat this private fund as a private equity fund instead of as a hedge fund for reporting purposes? **A.D.1:** No. In adopting the Form, the Commission considered, but did not accept, commenters' arguments that the leverage and shorting characteristics in the definition of "hedge fund" should focus on actual or contemplated use, rather than potential use. *See* Investment Advisers Act Release No. 3308, text accompanying footnote 78. However, if the private fund you advise is represented to investors as a type of fund other than a hedge fund (i.e., as a private equity fund, real estate fund or venture capital fund), you may, and the staff recommends that you do, include a note in Question 4 indicating the category of private fund that you believe better describes the fund and indicate why the reporting fund meets the definition of a hedge fund."

[6] *See id.*

[7] *See* Proposing Release, 87 Fed. Reg. at 53882 "Some reporting funds may consider themselves "private equity funds," but advisers report them as hedge funds, because the reporting fund's governing documents permit the fund to engage in certain borrowing and short selling (even though it did not do so at any time in the past 12 months)."

[8] We use this term broadly to include funds making primarily private investments generally, but not always, through a closed-end fund.

[9] *See* Proposing Release, 87 Fed. Reg. at 53882.

"N/A" responses by filers. Such responses are wholly unhelpful for FSOC, the Commission and the Commission and the Commodity Futures Trading Commission ("CFTC").

On the other hand, private equity funds that meet the definition of *hedge fund* under Form PF are not required to provide responses to items in Section 4 of Form PF, including for such metrics as the debt-to-equity ratio of controlled portfolio companies, amounts of interest payments made as payments-in-kind, issuer concentration, industry concentration and geographic concentration. We understand the purpose of requesting information on such metrics, for FSOC's ability to monitor systemic risk,[10] and believe they are also likely helpful to the Commission for purposes of understanding risks to investors in these *private funds*, potential conflicts of interest and compliance with stated investment goals and contractual restrictions. The effective result of the current, overbroad definition of *hedge fund* is to deprive the Commission of relevant information about a number of private equity funds that are required to report on Form PF as *hedge funds*, while instead causing such funds to report information on Section 2 of Form PF, resulting in less accurate data in the aggregate concerning the hedge fund industry. The Commission and CFTC acknowledged this potential issue in the Proposing Release in stating that "[a] potential unintended consequence of the existing reporting approach for hedge funds could be incomplete data sets for private equity funds, as well as less accurate reporting about hedge funds."[11]

For many of the same reasons as the CFTC stated in the Proposing Release, we believe that this definition results in unintended, burdensome and unhelpful reporting from private equity funds that are incorrectly characterized as *hedge funds*. We agree with the assertion in the Proposing Release that "a revised definition could better ensure advisers report information in closer accordance with their characteristics."[12]

2. <u>In Addition to the Considered Changes, the Definition of *Hedge Fund* Would Benefit from Additional Specificity to Further the Commission's Goals</u>

Under the Proposing Release, the Commission has noted that it is considering modifying the definition of *hedge fund* to require, in addition to having the <u>ability</u> to borrow an amount in excess of one-half of its net asset value or may have gross notional exposure in excess of twice its net asset value, that a *private fund* <u>actually</u> borrowed or used <u>any</u> leverage during the past 12 months, excluding any borrowings secured by unfunded commitments, to meet the leverage prong.[13] Further, under the Commission's considered approach, a hedge fund would have to actually engage

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[10] *See* Adopting Release at 71148, footnote 243 discussing listed equities: "However, based on our consultation with staff representing FSOC's members, we believe that turnover will provide important insight into the role of hedge funds in providing trading liquidity in certain markets."
See id. at 71154, footnote 315 discussing debt-to-equity ratio, "While this measure may have its limitations, the Commission believes, based on its staff's consultations with staff representing FSOC's members, that this question will provide an important indication of portfolio company leverage and is not aware of an alternative that would yield more reliable information without imposing additional burdens on advisers."
See id., footnote 318 discussing payment-in-kind: "The indebtedness in question, however, allows the borrower to increase its leverage by deferring interest payments (all at a time subsequent to the creditors making their credit determinations) and may result in additional risk being shifted to systemically important financial institutions or other holders of the debt."
[11] *See* Proposing Release, 87 Fed. Reg. at 53883.
[12] *See id.* at 53882.
[13] *See id.*

in certain short selling during the past 12 months.[14] We support these changes as we believe that, together, they would mitigate the misclassification of private equity funds as *hedge funds* solely based on such funds having the ability to borrow or sell assets short when it is not a practice that they typically engage in. We recommend, however, that the Commission modify these two prongs, as described below, in order to further its goals.

Under the Commission's current suggested revision, the leverage prong in the definition of *hedge fund* would be amended to require that a *private fund* "[has] actually borrowed or used any leverage during the past 12 months, excluding any borrowings secured by unfunded commitments (i.e., subscription lines of credit)."[15] We worry that, as currently considered, such a requirement would be overly broad and would unintentionally capture private equity funds that borrow small amounts under so-called "back-leverage" facilities in amounts equal to much less than one-half of their net assets in order to manage liquidity needs. We recommend that the Commission require that, to qualify as a *hedge fund,* a *private fund* must have actually borrowed in excess of one-half of its net asset value (including *committed capital*) or have had gross notional exposure in excess of twice its net asset value (including *committed capital*) within the past 12 months (excluding any borrowing secured by unfunded commitments).

Further, we recommend that the Commission modify slightly its considered change to the short-selling prong in the definition of *hedge fund*. As currently considered in the Proposing Release, a *private fund* that engaged in "certain short selling" during the past 12 months (other than for the purpose of hedging currency exposure or managing duration) would be classified as a *hedge fund*. While rare, in our experience, there are circumstances under which a private equity fund finds it appropriate to enter into a short transaction (e.g., where a *private fund* holds the publicly traded security of a portfolio company after its initial public offering and seeks to hedge its exposure). As a result, we recommend that the Commission create an exception for a de minimis level of shorting, relative to the size of the *private fund.*

In our view, each of these amended requirements in the definition of *hedge fund* would further the Commission's initial intention to "include any private fund having one of three common characteristics of a hedge fund: (1) a performance fee, (2), leverage, or (3) short selling."[16]

3. In Addition to the Changes Considered, the Commission Should Consider Whether a *Private Fund* Represents Itself as a Hedge Fund in Determining if It Qualifies as a *Hedge Fund*

In addition to the modifications described above, we recommend incorporating into the definition of *hedge fund* a rebuttable presumption that if a *private fund* has made any representations to investors and potential investors that it pursues a typical hedge fund-type strategy (such as absolute return, long-short equity, public credit, merger arbitrage, etc.), then it is a *hedge fund* and, conversely, that if a *private fund* has represented to investors and potential investors that it pursues a private equity-type strategy (such as private equity, private credit, infrastructure, real estate etc.), then it is not a *hedge fund*. While we acknowledge that this distinction may appear imprecise, it is analogous to what has been implemented in the context of adviser registration under Section

[14] *See id.*
[15] *See id.*
[16] *See id.*

203(l) of the Investment Advisers Act of 1940 (as amended, the "Advisers Act"). Rule 203(l)-1(a)(1) requires a fund classified as a venture capital fund for purposes of the so-called "Venture Capital Exemption" to be one that "represents to investors and potential investors that it pursues a venture capital strategy."[17] As is the case under the Venture Capital Exemption, we believe that the "holding out" criterion should "[depend] on all of the statements (and omissions) made by the fund to its investors and prospective investors."[18] We believe this approach would also substantially mitigate the Adopting Release's stated concern that the practices of certain hedge funds during the reporting period may impact their reporting (i.e., if they have not used such an amount of leverage or sold assets short during the prior 12 months, they would not qualify as *hedge funds*) and would avoid fluctuations in the data as it would capture funds pursuing a hedge fund-type strategy even where such funds did not engage in certain levels or borrowing or short selling during the reporting period.[19] Alternatively, a private equity fund might be an evergreen fund that charges a performance fee based on unrealized gains, but in all other respects functions as a traditional private equity fund buying majority stakes in private companies. This presumption would allow such a fund to report its portfolio composition in Section 4, providing far more useful information than including mostly "N/A" responses in Section 2.

We also recognize that advisers make many statements on behalf of their funds about the nature of the funds' investment strategies and that an adviser could, in theory, falsely claim that a *private fund* pursues a private equity or a hedge fund-type strategy in order to avoid certain Form PF reporting requirements. As with the Venture Capital Exemption, though, this framework is protected by Rule 206(4)-8 which states, in relevant part, that:

> it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the [Advisers] Act for any investment adviser to a pooled investment vehicle to: (1) make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle…[20]

The Commission in the case of the "Venture Capital Exemption" has determined that Rule 206(4)-8, in addition to other anti-fraud provisions of the Advisers Act, is a reasonable deterrent against advisers making untrue and misleading statements on behalf of *private funds*. We believe that it would also provide an appropriate and well-tailored constraint in the context of Form PF.

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In summary, we agree that an amendment to the term *hedge fund*, similar to what was considered in the Proposing Release, would make reporting by *private funds* more apt and useful. We also

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[17] *See* Rule 303(I)-1(a)(1) under the Investment Advisers Act of 1940, as amended.

[18] *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 76 Fed. Reg. 39645 (Jul. 6, 2011) at 39664.

[19] *See* Proposing Release, 87 Fed. Reg. at 53883, "Because a reporting fund may vary from year to year in its use of leverage or short selling, a revised definition that focuses on actual or contemplated use would also cause fluctuations in the data from year to year, depending on which funds use leverage or short selling in a particular year, potentially impacting the quality or usefulness of resulting data."

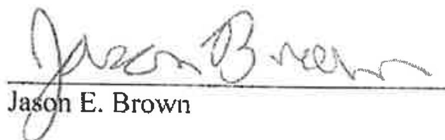
[20] *See* Rule 206(4)-8 under the Investment Advisers Act of 1940, as amended.

believe, however, that the classification of *hedge funds* could be bolstered by including in the amended definition a qualification that such *private funds* be held out as hedge funds.

Again, we thank you for the opportunity to provide these comments. We stand ready to provide additional comments or to answer any questions you may have.

Very truly yours,

Ropes & Gray LLP



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