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SEC and CFTC Propose to Amend Form PF Reporting Requirements to Include New Asset Subclass for “Digital Assets”

The Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”) have jointly issued a release proposing amendments to Form PF, a confidential reporting form for certain SEC-registered investment advisers to private funds, that would require covered investment advisers to report on certain digital asset investments for the first time.

Form PF was created in response to the financial crisis in order to provide greater transparency to regulators regarding the size and type of assets held by private funds, and these forms, in turn, are intended to enable the Financial Stability Oversight Council (“FSOC”) to assess systemic risk in the broader U.S. financial system. The FSOC was established pursuant to the Dodd-Frank Act as a collaborative body consisting of federal and state regulators and an independent insurance expert to promote collective accountability for identifying risks and responding to emerging threats to financial stability.

Form PF was jointly adopted by the SEC and CFTC in order to help the FSOC fulfill its mandate. In addition, the information collected may be used by the SEC and CFTC in conducting their respective regulatory programs (for example, the SEC will review information on Form PF in connection with examining investment advisers). Form PF filings are not public. At base, the disclosures provide regulators and the FSOC insight into a fund’s portfolio concentration, leverage, and any large exposures to specific assets and counterparties.

Among several of the SEC’s and CFTC’s proposed changes to Form PF are amendments to Section 2b, under which advisers to large hedge funds are required to report certain additional information, including a fund’s liquidity, its base currency, its investors, the concentration of its positions, and specific financing information. This section is designed to assist the FSOC in monitoring system-wide risk in the financial sector by requiring detail as to the composition of hedge funds’ exposures to different asset classes. Specifically, the proposed amendment creates a new sub-class within Section 2b for digital assets in light of “the growth as well as the volatility of this asset class in recent years.” In proposing the amendment, the CFTC and SEC also observed that not only are various existing hedge funds allocating portions of their portfolios to digital assets, but many new hedge funds are being formed for the specific purpose of investing in digital assets.

This notice of proposed amendments was prompted, at least in part, by recent significant volatility in digital asset prices, along with substantial growth in the number of private funds holding these assets. The across-the-board collapse in cryptocurrency prices earlier this year has spurred regulators to understand better the risks that the digital asset markets could pose to the broader economy. While the recent drop in prices for digital tokens has been relatively contained to the digital asset markets, the collapse of crypto-focused hedge fund Three Arrows Capital Ltd. raised alarm bells when a number of its creditors subsequently went into bankruptcy. Moreover, private funds have grown considerably over the last decade and are poised to surpass the size of the commercial banking sector. As growing numbers of mainstream financial institutions increase their adoption of digital assets, regulators have expressed concern about possible similar ripple effects in traditional markets.

In fact, SEC Chair Gary Gensler stated that a “very significant part of our financial system is growing—and growing faster, and is about to overtake the entire commercial banking system—[but] has far less regulation and far less transparency[.] . . . With this final rule, regulators will gain transparency into an important sector of the financial marketplace to better assess risk to the overall system[.]” Chairperson Gensler has frequently expressed his view that investor protection in the digital asset markets is insufficient. At the same time, as recognized in President Biden’s May

9, 2022 Executive Order, regulators recognize that it is imperative for the U.S. to maintain its global leadership in financial and technological innovation and competitiveness, so it is critical that regulatory changes not be unduly burdensome or restrictive.

The proposed rule is available for public comment until October 11, 2022. Specifically, the agencies have requested comments on whether private funds should be required to report detailed information regarding the cryptocurrencies they hold, such as identifying them by name or describing their precise characteristics.

If you would like to learn more about the issues in this Alert and how they may impact your interests, or if you are potentially interested in submitting a comment on the proposed rule, please contact your usual Ropes & Gray attorney.