GLOBAL
RISK
MANAGEMENT
ADVISORS

Risk & Investment
Management

# Form PF Update

April 16, 2013

GLOBAL
RISK
MANAGEMENT
ADVISORS
Risk & Investment Management

Global Risk Management Advisors ("GRMA") is pleased to provide a Form PF update based upon our most recent experience working with major funds and advising major law firms, primes, administrators and the regulators.

## Where Do Funds Currently Stand re: Form PF?

- ***Continued Difficulty with Interpretation and Assumptions***: we are finding that both "first filers" that have now completed their third filing and "second filers" that filed their initial filing in March are uncertain about whether the interpretations they used in answering Form PF questions are all correct and in line with what the regulators view as reasonable. For example, funds continue to struggle to understand which Form PF questions require notional value of derivatives positions and which require market value. Also funds are unsure for which Form PF questions to provide written assumptions in Question 4 and how to word these assumptions so that they do not trigger any regulatory "red flags."

- ***Manual Form PF Process:*** many first filers continue to utilize a largely manual Form PF process that is riddled with "cut and pasting" to extract and transform data and generate the final XML upload file. Such manual processes are costly and introduce significant operational risk. We have seen that second filers are even more likely to rely on mostly manual Form PF processes because they generally have fewer resources to devote to their Form PF program.

- ***Significant Mistakes Found:*** we have found from our work with a broad spectrum of clients and service providers that many funds do not realize that they have material mistakes in their filings. These mistakes were driven mainly by invalid interpretations and assumptions or improper methodology and are causing funds to inadvertently file materially inaccurate responses with the SEC/CFTC.

- ***"Playing Chicken" With the SEC:*** finally, we have observed a number of funds "playing chicken" with the regulators by not answering some of the risk questions that they deem to be difficult to calculate or not applicable for their fund. One of the main objectives of Form PF is to collect information on aggregate systemic risk from hedge funds, for which regulators need responses to Questions 41 and 42 from a substantial majority of Form PF filers. The regulators cannot meet their aim of assessing systemic risk if funds opt not to answer some of the questions in Form PF. Also, we believe that not providing this information raises doubts about the quality of a fund's risk management process. Therefore, GRMA advises our clients that failing to provide risk data such as durations, stress test results and VaR in their Form PF filing casts a fund in an unfavorable light to the regulators and may contribute to moving a fund to the "front of the line" for regulatory examination.

- ***More FAQs to Come:*** The SEC has indicated that it plans to issue FAQs on a regular basis to help clarify issues around interpretation. On March 8, it released new FAQs for Instructions A.5, F.4, G.2 and H.2 and Questions 24, 26, 35, 44, 49 and 50 (see GRMA's attached compilation of just the FAQs issued in March).

# GRMA's Focus for Form PF

GRMA has been working with both funds that have already completed several filings as well as funds that made their initial filing in March. Currently, our value-added Form PF advisory and implementation services focus on four principal areas:

1. ***Interpretation/Assumptions:*** ensuring that our clients are using correct interpretations and assumptions as the basis for their answers in Form PF.

2. ***Review, Check and Audit:*** reviewing and checking a client's filings to ensure that they are an accurate portrayal of a fund's risk profile and that there are no glaring regulatory or investor "red flags" in the filing.

3. ***Sound, Cost-Effective and Sustainable Process:*** ensuring that our clients have in place a sound, efficient, repeatable cost-effective program for Form PF.

4. ***Proper Documentation/Regulatory Audit Trails:*** ensuring that our clients have proper documentation of their Form PF process, such as a Form PF manual that establishes clear roles and responsibilities for each Form PF team member; and ensuring that our clients have proper regulatory audit trails so that they can fully explain and justify how they developed their answers to the regulators and their investors.

# Why GRMA?

What sets GRMA apart is that we combine our extensive risk management expertise and thought leadership on Form PF with extensive hands-on experience to provide our clients with:

- ***Complete and Cost-effective Solution*** – provide a complete and cost-effective Form PF solution that is sound, repeatable and sustainable.
- ***Interpretation*** – provide much needed expertise to properly interpret the questions in Form PF.
- ***Assumptions and Risk Methodologies*** – evaluate and/or develop key assumptions, risk methodologies and complex calculated answers for a proper filing and to minimize the risk of regulatory and investor "red flags" in your filing.
- ***Enhanced Risk Management*** – enhance your risk management program as it relates to Form PF.
- ***Consistency*** – ensure more consistent risk representation across all fund documents.
- ***Essential Review*** – perform independent final review, check and audit of your Form PF filing before submission to the SEC.
- ***Independence*** – provide substantive and optical value for investors and regulators through our well-recognized status as independent risk and Form PF experts.

We have attached a copy of our most recent "Form PF Advisory and Implementation Services" two-pager that fully describes how we work with funds to ensure that they have a sound, sustainable and repeatable Form PF process, as well as GRMA's compilation of the FAQs issued by the SEC on March 8, 2013.

We would be happy to discuss in more detail how we can assist you to improve your own Form PF process.

Risk & Investment
Management

# SEC's Form PF FAQs

(Issued March 8, 2013)[1]

[1] FAQs issued on 3/8/13 were excerpted from list of all Form PF FAQs posted on SEC's website.

| FAQ # | SEC's Form PF FAQs – March 8, 2013 |
|---|---|
| **Q. A.5:** | **Am I required to identify all of my related persons in Question 1(b)?** |
| A. A.5: | No. Form PF permits (but does not require) related persons to report on a single Form PF information with respect to such related persons and the private funds they advise as a matter of convenience for affiliated entities. See Instruction 2. You are only required to identify a related person in Question 1(b) if you are reporting information on your Form PF with respect to that related person. |
| **Q. F.4:** | **If I disregarded a private fund or equity investments in other private funds when reporting the fund's assets in Questions 3, 8, and 9, do I also disregard such assets when responding to Question 15 and 16?** |
| A. F.4: | No. Unlike the other questions that ask about the reporting fund's underlying assets, Questions 15 and 16 ask information about the reporting fund's beneficial owners. |
| **Q. G.2:** | **How should I treat short positions, derivatives, repurchase agreements, total return swaps, and other financial instruments for purposes of calculating regulatory assets under management in Question 3 and for purposes of calculating a reporting fund's gross asset value in Question 8?** |
| A. G.2: | If the private fund has a balance sheet, you may rely on the gross assets reflected on the balance sheet to calculate "regulatory assets under management" and "gross asset value." Accordingly, you need not assess the value of these financial instruments in a manner different from that required under the applicable accounting standard. *See* Frequently Asked Questions on Form ADV and IARD (Form ADV: Item 7.B).<br><br>For example, when determining whether to include short positions, the short position should be included when it is an asset on the balance sheet in accordance with the applicable accounting standard. Typically, a short sale will be recorded as a short sale liability (because the fund has an obligation to replace the security) together with an asset for the proceeds received or due from the counterparty (*e.g.*, cash received or due from a broker). In that case, the short sale liability would neither be included as an asset nor deducted from assets in the calculation of "gross asset value," although the proceeds received would be included in "gross asset value." However, if the fund takes a short position using a derivative, the derivative itself may have a positive fair value and be recorded as an asset. In this case, the short position would be included as an asset in the calculation of "gross asset value." *See* Investment Adviser Release 3221, footnote 83. |

| FAQ # | SEC's Form PF FAQs – March 8, 2013 |
|---|---|
| **Q. H.1:** | **If I reported private funds in a master-feeder arrangement on an aggregated basis for purposes of Form ADV, Section 7.B.1, am I required to report the master-feeder arrangement on an aggregated basis on Form PF?** |
| A. H.1: | Yes. In order to report the funds in such master-feeder arrangement separately on Form PF, you should file an other-than-annual amendment to your Form ADV to reflect such change before you file your Form PF. |
| **Q. H.2:** | **If I elect to aggregate a master-feeder arrangement for reporting purposes in accordance with Instruction 6, how do I respond to questions regarding the investors of the master-feeder arrangement?** |
| A. H.2: | Instruction 6 specifies that, if you are reporting a master-feeder arrangement on an aggregated basis, you must treat the aggregated funds as if they were all one private fund. Accordingly, you should collapse the master-feeder structure and aggregate all investors in the master-feeder arrangement (but do not count the feeder funds themselves as investors) when responding to questions about investors of the master-feeder arrangement. For example, in a master-feeder arrangement where there are no direct investors in the master fund other than the feeder funds, you should report the approximate percentage beneficially owned by the investors of the feeder funds as calculated on an aggregate basis when responding to Questions 15 and 16 regarding beneficial ownership and you should report the liquidity of the investors of the feeder funds when responding to Question 50 about investor liquidity. |

| FAQ # | SEC's Form PF FAQs – March 8, 2013 |
|---|---|
| **Q. 24.2:** | **How should I calculate the percentage of derivatives trade volume in Questions 24(b) and 24(c) for a fund?** |
| A. 24.2: | In determining the trade volume percentage of derivatives trades for purposes of Questions 24(b) and 24(c), you should use the weighted-average of the notional amount of the aggregate derivatives transactions (except for options, in which case you would use the delta adjusted notional value, and interest rate derivatives, in which case you would use the 10-year bond equivalent) entered into by the fund during the reporting period. For example, assume the reporting fund only entered into the following three trades during the reporting period: (i) purchased contracts of gold on the futures exchange worth $50,000, (ii) entered into an over-the-counter interest rate swap that was cleared by a CCP with a 10-year bond equivalent of $1,000,000, and (iii) purchased an over-the-counter call option that was not cleared by a CCP with a delta equivalent of $500,000. You would compute the fund's trade volume as follows:<br>i. For Question 24(b), because the futures transaction was the only transaction that was traded on a regulated exchange or swap execution facility, the fund should report 3% ($50,000/$1,550,000) on the first line and 97% ($1,500,000/$1,550,000) on the second line.<br><br>For Question 24(c), because the futures transaction and the interest rate swap were cleared by a CCP, the fund should report 68% ($1,050,000/$1,550,000) on the first line and 32% ($500,000/$1,550,000) on the second line. |
| **Q. 26.3:** | **The definitions for certain fixed-income asset and sub-asset classes in Questions 26 and 30 require us to include certain types of derivatives on the particular asset or sub-asset classes when measuring exposure for such asset or sub-asset class. See "corporate bonds," "convertible bonds," "GSE bonds," and "sovereign bonds". Should we also include derivative exposures when measuring exposures to each of the sub-asset classes under the "ABS/structured products" asset class (i.e., "MBS," "ABCP," "CDO/CLO," "Other ABS," and "Other structured products")?** |
| A. 26.3: | Yes. The instructions to Question 26 and 30 specify that you should include all exposure whether held physically, synthetically, or through derivatives. For example, you should categorize a forward position on a mortgage-backed security in the "MBS" sub-asset class in the "ABS/structured products" asset class and report the notional amount of the forward position. |
| **FAQ #** | **SEC's Form PF FAQs – March 8, 2013** |

| | |
|---|---|
| **Q. 26.4:** | **Instruction 15 states that, unless otherwise specifically indicated, the value of derivatives (other than options) should be reported in terms of such derivatives' gross notional value. The definition of "interest rate derivative", however, requires filers to present this information in terms of 10-year bond equivalents. How should I report a reporting fund's exposure to interest rate derivatives in Questions 26 and 30?** |
| A. 26.4: | Because Instruction 15 applies unless otherwise specifically indicated, you should follow the requirement in the definition and report the exposure of interest rate derivatives in terms of 10-year bond equivalents. |
| **Q. 35.1:** | **When reporting a reporting fund's relevant open positions, should I report a short position that represents more than 5% of the reporting fund's net asset value as a negative value?** |
| A. 35.1: | Yes. |
| **Q. 44.2:** | **When reporting the aggregate value of all derivatives positions of a reporting fund in either Question 13(b) or Question 44, may I report a negative number?** |
| A. 44.2: | No. You should report the absolute value of outstanding derivatives position. |

| FAQ # | SEC's Form PF FAQs – March 8, 2013 |
|---|---|
| **Q. 49.1:** | **Questions 49(c) and 49(e) and Questions 63(b) and 63(d) ask about the percentage of a reporting fund's net asset value that may be subjected, or is subject, to material restrictions on investor withdrawals/redemption. When responding to these questions, should I take into account every type of material liquidity restrictions associated with the reporting fund?** |
| A. 49.1: | The instructions to Question 49 and Question 63 note that you should make a good faith determination of withdrawal/redemption provisions that would likely be triggered during conditions that you view as significant market stress. Accordingly, when responding to these questions, you should only take into account discretionary restrictions that the adviser or fund governing body may impose on the reporting fund above any baseline liquidity restrictions an investor is already subject to in the ordinary course as terms of its investment in the fund. For example, if a fund you manage generally imposes a 1-year initial lock-up period before an investor may make withdrawals/redemptions or only allows for annual withdrawals/redemptions upon 60 days' notice, you should not take any of these restrictions into account when responding to Question 49 and Question 63 because these restrictions will be accounted for in responses to Question 50. |
| **Q. 49.2:** | **Should I include assets subject to a side-pocket arrangement when responding to Questions 49(c) and 49(e) and Questions 63(b) and 63(d) regarding the reporting fund's net asset value that may be subjected, or is subject, to material restrictions on investor withdrawals/redemptions?** |
| A. 49.2: | No. You should, however, report the percentage of the reporting fund's net asset value, if any, that is actually in a side-pocket as of the data reporting date in Question 48(a). |
| **Q. 50.1:** | **Question 50 and Question 64 ask for the breakdown of the percentage of the reporting fund's net asset value that is locked in for different periods of time. When responding to these questions, should I take into account the investor liquidity associated with each different investor, such as different lock-up periods or side-letter terms associated with different investors?** |
| A. 50.1: | Yes. You should evaluate the specific liquidity terms applicable to each investment as of the data reporting date, and then calculate the percentage of net asset value associated with each time period identified in the questions. |

| FAQ # | SEC's Form PF FAQs – March 8, 2013 |
| --- | --- |
| **Q. 57** | **See Question 35 above.** |
| **Q. 63** | **See Question 49 above.** |
| **Q. 64** | **See Question 50 above** |
| **Q. 77.1:** | **Question 77 asks for a breakdown of a reporting fund's investments in portfolio companies by NAICS codes of the companies. Should the breakdown be based on the percentage of the total gross value of the reporting fund's investments in portfolio companies attributable to specific NAICS codes?** |
| A. 77.1: | Yes. |