The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com | Volume 5, Number 4 | January 26, 2012

Form PF

Form PF: Operational Challenges and Strategic, Regulatory and Investor-Related Implications for Hedge Fund Managers

By Samuel K. Won and David Vaughan

In October 2011, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) adopted the much-anticipated final rule for Form PF, which requires reporting of risk measurement information by registered investment advisers regarding the private funds they manage. As hoped, the agencies made a number of modifications to the proposed form to ease some of the burdens associated with these new risk-reporting requirements. Specifically, the agencies established a minimum assets under management threshold for filing Form PF, raised the threshold for detailed hedge fund reporting, extended the length of time hedge fund advisers would have to file and the start date for compliance. However, the core elements of the new reporting requirements remain largely unchanged, especially since there has been no substantial reduction in the volume of information required. Therefore, although some improvements to the form have been made, we believe it is still likely to pose significant challenges for many hedge fund managers, especially with regard to implementation.

Now that the new Form PF rules have been adopted, there have been flurries of e-mail blasts sent from law firms and other hedge fund service providers to their clients to summarize the major requirements of the final rules and to highlight the notable differences between the proposed rules and the final rules. However, the purpose of this article is not to provide such a summary or to highlight the differences but to point out some of the major operational challenges that many funds will face in the preparation and implementation required to complete Form PF and to provide guidance on some of the larger strategic and investor-related implications stemming from Form PF. The article begins with a discussion of the Form PF reporting requirements. The article then explains the operational challenges that many hedge fund managers face in accurately and timely gathering and reporting information required by Form PF. The article then moves to a discussion of the strategic, regulatory and investor-related implications raised by Form PF. Finally, the article concludes with a discussion of recommendations designed to address the operational and other challenges hedge fund managers face with respect to Form PF.

What Form PF Requires

Registered hedge fund managers with $1.5 billion in hedge fund regulatory assets under management (i.e., gross balance sheet assets) will be required to file detailed information about those funds on Form PF within 60 days following the end of each fiscal quarter. This information includes a substantial amount of performance and detailed risk measurement data about the hedge funds, with individual fund reporting requirements for each fund with $500 million or more in net assets. Hedge fund managers with fewer assets under management will file basic information annually within 120 days of the fiscal year-end, and hedge fund managers with less than $150 million in private fund assets will not have to file Form PF. The information will be non-public and is intended primarily for the assessment of systemic risk by the Financial Stability Oversight Council (FSOC). However, it is important to note that the SEC will have access to the information and may use it for its own regulatory purposes – including enforcement actions.

Operational Challenges for Hedge Fund Managers

Most hedge fund managers took a "wait and see" approach awaiting the final version of Form PF while hoping for a substantial reduction in the amount of information required. Unfortunately, managers hoping for a reduction in the amount of information required have been disappointed.

From an operational perspective, many hedge fund managers will face challenges in meeting the initial filing date, as well as subsequent reporting deadlines, because they currently do little or nothing in the way of formal risk measurement analysis and most likely do not produce all of this information in the format that the SEC now requires from them. Furthermore, this shortfall is exacerbated by the fact that many hedge fund managers do not possess the necessary technology and risk infrastructure, staffing and internal processes to produce these reports in an accurate and timely manner. These operational impediments will be especially problematic for funds that are depending solely upon their service providers, such as their fund administrators, to provide them with all of the risk information and data needed to complete Form PF on an ongoing basis. Many service providers likely are ill-prepared to provide risk data and related information to their clients because this has never been their core competency nor has it been required in the past by their clients. At best, many service providers can only provide a partial solution for supplying risk data to their fund clients.

Strategic, Regulatory and Investor-Related Implications of Form PF

Many hedge fund managers perceive the submission of Form PF simply as a compliance requirement for which they have to submit voluminous risk data to the SEC. These hedge fund managers are missing the proverbial "forest for the trees," and do not realize the significant investor, risk and strategic implications arising from Form PF. As a result, these hedge fund managers may be exposing themselves to significant legal and regulatory risks, greater investor scrutiny and even redemptions. The following are some of the notable risks and implications that we believe may affect hedge fund managers.

Investors' Window on Risk

Many investors, particularly institutional investors, will ask hedge fund managers to provide them with a copy of the firm's Form PF submission to the regulators. The Form PF submission will provide investors with a "window" into what a hedge fund manager does and does not do for risk management. Historically, some of the information required in Form PF may have been calculated by hedge fund managers but not reported to investors. However, going forward, it will be very difficult for hedge fund managers to refuse to provide this information to investors who request it. Hedge fund managers will no longer be able to argue that it is not cost effective to calculate the data points included in Form PF for investors because investors will know they have already been calculated for the regulators. Therefore, some institutional investors and investing fiduciaries may feel compelled to request this information, knowing that it has already been calculated by hedge fund managers.

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For example, in light of the detailed risk disclosures required by Form PF, investors could ask hedge fund managers to provide information about their calculation of value at risk (VaR). For those hedge fund managers that calculate VaR and report it on Form PF, investors would now be able to see that measurement of market risk by examining the information reported in Form PF. Notwithstanding regulators' attempts to indicate that other risk measures could be used, as a practical matter, hedge fund managers that do not calculate VaR will have to be ready to explain why they do not calculate and use this "universal" risk statistic.

In addition, a number of questions in Section 2B of Form PF require a hedge fund manager to disclose the impact on the long and short components of the fund's portfolio of specified changes to certain identified market factors that a fund evaluates in risk management. In essence, the regulators are asking hedge fund managers to provide them with a form of stress testing information. As mentioned above, investors will most certainly get access to this information by asking for or pressuring their hedge fund managers to divulge it.

Greater Regulatory Scrutiny

In the long term, we believe there is a high likelihood that the SEC and/or some other regulatory agency will go beyond asking funds to simply provide risk data and will evaluate a fund's infrastructure, processes and controls to determine how well a fund measures and manages its investment risks. The precedents exist for this to happen. For many years, the Board of Governors of the Federal Reserve (Federal Reserve), the Office of the Comptroller of the Currency and the U.K. Financial Services Authority have not only received risk data at regular intervals from the financial institutions they regulate but also evaluated how well these financial institutions perform risk management as part of their periodic regulatory examinations. Furthermore, European regulators have been pushing for greater regulatory oversight and examination of hedge fund managers and other alternative investment advisers. The Europeans backed off from pushing unilateral initiatives that would affect U.S. hedge fund managers only after much arm-twisting by Tim Geithner and the U.S. Department of the Treasury. Global initiatives to further regulate hedge fund managers and other alternative investment advisers have only been temporarily delayed because of the intense focus on the health and soundness of the major banks and because of the attention on sovereign risk and contagion.

Risk Data You Report – Realistic or Not?

Up to this point, some hedge fund managers that calculate formal risk statistics may have done so merely as "window dressing" to appease investors. Many of these hedge fund managers have been uncertain about whether the risk statistics they generate are accurate or even realistic. Not surprisingly, some hedge fund managers may have also used model assumptions to calculate risk statistics that present their funds' market risk in the best possible light to their investors. Now that the SEC requires hedge fund managers that calculate formal risk statistics to report these metrics: does a hedge fund manager report risk statistics to the SEC knowing that these figures are not realistic? Alternatively, does a hedge fund manager recalculate its risk statistics and face investor questions about the changes in practice? Regardless of which of these paths a manager chooses, it may find itself in a dilemma with potentially serious legal, regulatory and investor risk implications.

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Anticipated Demand for Greater Transparency

We believe that Form PF will be one of the key triggers that force the opening of "Pandora's box." One of the major consequences of Form PF is that it will eventually force hedge fund managers to provide greater overall risk transparency to investors. This trend, which started after the financial crisis began in 2008, has not subsided and continues to pick up greater momentum. There are already several initiatives under way by a consortium of institutional investors and hedge fund service providers to improve and standardize the risk information that hedge fund managers provide to investors (e.g., Opera initiative).

Lingering Confidentiality Concerns

By adopting Form PF, regulators sought to ease concerns in the industry regarding the potential for either an inadvertent or intentional leak of Form PF data. While those efforts to ease industry concerns were certainly positive, there are continuing questions about how effective those measures will be. Moreover, given Congressional access to the information and the risks of misuse if the information is routinely provided to investors, hedge fund managers should consider how best to manage the risk that their Form PF data could reach the wrong hands.

Recommendations

Prepare Early

Building the necessary and proper technology infrastructure and processes to calculate, verify and report the required risk data and information for Form PF is a lengthy process that can take many months, especially for those hedge fund managers that do not already possess the infrastructure, processes and personnel. If they are considering using an external risk adviser or consultant, they need to ensure that the risk professional has the proper risk pedigree and experience with this kind of infrastructure. The type of risk infrastructure design and build required by Form PF is not merely a simple information technology project.

Do Not Rely Exclusively on Your Service Providers

If a hedge fund manager is going to rely upon its service providers, it must realize that many service providers, such as its fund administrator, can only provide a partial solution covering some of the required risk data and information. Hedge fund managers will need to assess where and how they are going to obtain the balance of the information that their service providers cannot furnish and how they will aggregate, verify and produce this information on an ongoing basis to satisfy their regulatory requirements.

Prepare for Heightened Regulatory Scrutiny

Now that the final version of Form PF has been adopted, hedge fund managers should move quickly and apply adequate resources to prepare not just for the filing of Form PF itself, but also for the in depth examinations of the information and data now required for Form PF submissions that regulatory agencies are sure to perform. The SEC will be scrutinizing, in depth, the risk management systems of hedge fund managers. Initially, this will likely focus on whether the internal processes and procedures for gathering and reporting the data are sufficient. Outsourcing this function to a fund administrator is unlikely to be the end of the story. The SEC will probably want a better understanding of how much due diligence and continuing oversight the hedge fund manager is conducting to ensure the information is correct. Moreover, the Dodd-Frank Act deems the records of the hedge fund to be the records of the hedge fund manager. As a result, those records are fully subject to SEC examination, and the SEC staff can hold the hedge fund manager responsible for the information even if it is in the hands of the hedge fund.

In addition, as the Form PF adopting release points out, the FSOC has the ability to designate nonbank financial institutions (including hedge fund managers and their funds) for additional regulation by the Federal Reserve. However, short of this dramatic step, the FSOC has the ability to recommend that a primary financial regulator impose additional requirements on financial institutions for the purpose of mitigating systemic risk. This particular authority is cited in the Form PF adopting release. In the case of registered hedge fund managers, their primary regulator is the SEC.

Prepare for More Demands for Transparency

Hedge fund managers would be well served to assume that their investors will ask for a copy of their Form PF submission. Moreover, they need to realize that post 2008, we are in an environment where they will need to provide more transparency regarding risk to regulators as well as to existing and prospective investors. In the short term, hedge fund managers should be ready to provide investors, and potentially regulators, with a robust explanation of their risk data. Whether or not they use certain risk statistics, managers need to be prepared to fully explain why a particular risk statistic is or is not relevant to their strategy. Otherwise, this may be an indication that the hedge fund manager either is not sophisticated about risk management or is not paying the appropriate amount of attention to it. In preparation for the long term, hedge fund managers should adapt to provide heightened transparency. They must not only make the necessary expenditures to improve their infrastructure, processes and controls to meet these requirements, but also, and more importantly, make the cultural adjustments to realize that, in the long term, it is in the best interest of their funds and the industry to provide robust transparency.

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