The Hedge Fund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 6, Number 4 January 24, 2013

Form PF

Challenges Faced By, Risks Encountered By and Lessons Learned From First Filers of Form PF

By Tim Wilson and Jonathan Miller

With the initial Form PF filings behind us, now is an opportune time to take stock of what lessons hedge fund advisers have learned from their experience with Form PF to date. In this article, we address, based on our work and discussions with first filers and other advisers, the following questions that advisers have asked us about Form PF:

- What were the major challenges that large hedge fund advisers faced in completing their August and November 2012 filings?
- What are the principal risks to which hedge fund advisers are exposed as a result of their filings?
- What lessons should hedge fund advisers draw from the experience of first filers?

Addressing these questions can assist all Form PF filers in avoiding critical mistakes in preparing for, completing and making future Form PF filings. The responses to these questions can be instrumental not only to those hedge fund advisers that have yet to make their initial Form PF filings, but also to those hedge fund advisers that will be making subsequent filings.

Overview of Form PF

The obligation to file Form PF, adopted by the SEC and the Commodity Futures Trading Commission (CFTC) in October 2011 pursuant to a mandate of Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act to gather data on private funds, applies to investment advisers that:

- Are registered (or required to be registered) with the SEC or are commodity pool operators (CPOs) or commodity trading advisors (CTAs) that are dually registered with the SEC and the CFTC;
- Advise one or more private funds (i.e., funds that rely on the exclusion from the definition of investment company provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940); and
- Collectively with related persons (other than related persons that are separately operated), have regulatory assets under management (RAUM) of $150 million or more attributable to private funds as of the end of the most recently completed fiscal year.

Reporting advisers meeting only the minimum $150 million private fund RAUM reporting threshold, as well as large private equity fund advisers (with at least $2 billion in private equity fund RAUM), must file Form PF annually within 120 days of their fiscal year-end. Large hedge fund advisers (with at least $1.5 billion in hedge fund RAUM) and large liquidity fund advisers (with at least $1 billion in liquidity fund/money market fund RAUM) must file quarterly, within 60 days of the quarter-end for a large hedge fund adviser and within 15 days for a large liquidity fund adviser.

Any large hedge fund adviser with at least $5 billion in hedge fund RAUM as of March 31, 2012, a so-called "first filer," was required to make its initial Form PF filing by August 29, 2012. The initial quarterly filing deadline for other large hedge fund advisers generally will be March 1, 2013, while the initial filing deadline for the annual filers (including large private equity fund advisers) generally will be April 30, 2013.

Major Challenges Experienced by First Filers

In the course of preparing their August and November 2012 filings, first filers found that three major components are required for a sound, repeatable and sustainable process for Form PF:

- Development of Form PF content;
- Data aggregation and creation of the XML file for upload to the regulators; and
- Verification and quality control of the filing before submission.

Form PF Content a Struggle

A big surprise for many first filers was the difficulty of accomplishing the first of these items – the development of the content for their Form PF responses.

- *Assumptions and methodologies*: One of the most significant challenges in terms of content has been determining what assumptions and methodologies to use. Even late in the process, many first filers remained uncertain as to what information the regulators were looking for in a number of ambiguous and/or unclear questions. The late release (in July 2012) by the SEC staff of major substantive additions to its Form PF Frequently Asked Questions (FAQs) shed some light on how to approach certain problematic questions. For example, one FAQ suggested that if a fund could calculate a risk metric requested by Form PF then it should do so, even if the fund did not routinely calculate that metric for internal purposes. As a result, many first filers had to scramble to implement new risk calculations at the last minute. Another FAQ indicated that reported "borrowings" must include securities borrowed and other financing arrangements, not just cash borrowed. This led many advisers to substantially revise their responses.
- *Information sourcing and mapping*: First filers often also struggled with decisions about what information sources to map to the responses for a number of difficult questions, given that there can be multiple, and often unreconciled, sources for specific data items (e.g., a fund's administrator, prime brokers and internal fund databases/spreadsheets).
- *Risk calculations*: Many hedge fund advisers historically have not done the specific risk calculations requested on Form PF, and many lack the internal capabilities to perform the calculations, including consistent and fund-wide Value at Risk (VaR) and stress testing. Even advisers with the capabilities to perform risk calculations faced challenges in determining how to implement the necessary calculations, such as what parameters to utilize for VaR calculations and how to stress test distressed debt that lacks a clear-cut duration.

Form PF Information Normalization, Aggregation and Quality Control

As noted above, information needed to populate Form PF is obtained from a variety of sources – including internal systems, fund administrators, prime brokers and custodians – and is often in different formats. Developing and implementing processes for normalizing and aggregating such diverse data (especially across strategies) in preparation for creation of the XML file can be demanding and complex. A major issue in this area has been how advisers can best evaluate and utilize third-party service providers, which themselves still may be coming up the learning curve for preparing Form PF, to assist them in normalizing and aggregating data needed for Form PF.

- *Difficulty of developing a robust Form PF process*: The most significant challenge with regard to data normalization and aggregation has been the development of a robust, repeatable and cost-effective Form PF process with good workflow design and sufficient automation, controls and audit trails. Many first filers had planned to automate their process and improve controls and audit trails after their initial filing. However, many advisers found that they lacked the internal resources and risk management expertise to implement these badly needed process improvements and controls by the time they completed their next filing (which was due on November 29, 2012).
- *Technology decisions and anticipating service provider challenges and limitations*: As part of the planning required to assemble a project team and mobilize and coordinate internal and external resources, many advisers had to decide whether to utilize various third-party service providers to assist them with Form PF. Most advisers also had to evaluate (in a short time frame) a range of Form PF-related technology choices, including whether to buy or build. Hedge fund advisers have found that their administrators, Form PF technology vendors and other service providers have encountered significant challenges with the breadth, ambiguity and complexity of Form PF and are still in the process of developing Form PF expertise. Also, while administrators and/or technology vendors can be very helpful with data management/aggregation and generation of the filing in XML format, a hedge fund adviser should not look to these service providers to make the difficult decisions regarding what specific assumptions and content the adviser should employ for its filing.
- *Verification and quality control of the filing before submission*: Hedge fund advisers must allocate adequate time and resources to error-check and reconcile the data used to prepare Form PF and to thoroughly review the draft filing before submission. Many first filers found that addressing issues that arose from Form PF's numerous ambiguities required significant discussion internally and with outside parties. They also found that they had to be prepared for unexpected contingencies. For example, some first filers learned that making a change to the answers in one question will affect the responses to other questions. Likewise, there were first filers that received critical information from a service provider only days before the filing was due, making it impossible to carry out a full final review of the complex filing. Not all first filers allowed time for, or elected to do, one or more test filings. Performing at least one test filing has emerged as a Form PF "best practice," because it can uncover errors, highlight missing information and alert advisers to problems in producing the final XML file for upload. There appears to be a growing misconception among many second filers that starting their process by doing a "dry run" test filing with their administrator is helpful as a starting point for tackling Form PF. In our experience, doing a test filing is most

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beneficial only after a hedge fund adviser has properly interpreted the Form PF questions and developed risk assumptions and risk methodologies that are specific to the fund and that will produce valid Form PF answers. Preparing a test filing before addressing these issues is neither useful nor informative because the hedge fund adviser will not be able to assess whether the resulting test filing is "correct," since there is no way to determine whether the right approach (interpretation, assumptions and risk methodology) was used to develop the answers.

Risks Hedge Fund Advisers Face From Their Form PF Filings

Once hedge fund advisers have filed Form PF with the regulators, a new challenge that arises is managing a range of resulting risks, including:

- *Operational risks created from manual processes*: Many first filers relied on relatively manual processes for their initial rounds of filings, causing the filings to be very time consuming to prepare and subject to a high risk of accidental error. The nature of these processes also makes it very difficult for hedge fund advisers to readily and transparently respond to questions the regulators may have regarding these filings.
- *Inadequate quality control for non-financial data*: The scope of Form PF is very broad, encompassing a great deal of information that is not subject to the audit procedures, checks and controls routinely applied to a fund's financial data. Many hedge fund advisers have struggled to gain comfort in the reliability of the information used to prepare Form PF.
- *Investor ramifications and consistency of risk representation*: The question of investor access to Form PF information has been the subject of much discussion. Some hedge fund advisers are planning to provide their filing upon request (with investor agreement to not disclose the information to other parties). Other hedge fund advisers anticipate preparing and making available to investors an extract of key Form PF information. Still other advisers may only allow viewing access to Form PF on the firm's premises. In any case, Form PF may show risk exposure and other data in a way that is different from an adviser's historical presentation to investors or show aspects of fund risk exposures that have not previously been shown to investors. Many advisers have expressed concern that Form PF may create investor relations issues by requiring risk or other data reporting in a manner that the adviser feels does not accurately reflect the fund's operations or that is inconsistent with other fund communications about the fund's risk profile (such as due diligence questionnaires, offering documents and monthly letters).

Actions to Be Taken Based on First Filer Experience

First filers generally devoted substantial time and resources to preparation of their August filings, in some cases starting in early to mid-2011, following publication of the Form PF rule proposal. In comparison, time frames for preparing Form PF going forward are highly compressed. First filers' second quarterly filings were due by November 29, 2012, and second filers have only a few months before their initial filings. Based on our experience with first filers, we believe it is critical that hedge fund advisers:

- *Do not delay*: Many first filers dramatically underestimated the time required to complete Form

PF. Given the volume and complexity of the work involved, it is essential that second filers and third filers commence work in earnest immediately, if they have not already done so. Most advisers will find that considerable planning and organization are necessary to promote effective collaboration among the firm's internal accounting, operations, technology, treasury, legal and compliance functions and multiple outside parties (e.g., Form PF consultants and/or technology vendors). Hedge fund advisers that do not make Form PF an urgent priority run a significant risk of failing to complete their initial filings in a timely and adequate manner.

- *Pay careful attention to assumptions and interpretations*: A number of instructions, definitions and questions in Form PF are subject to interpretation, requiring advisers to make many assumptions. The July and November FAQs notwithstanding, the regulators so far have provided very limited guidance, and many questions and ambiguities remain even after the first rounds of filings. Advisers generally should plan to memorialize how they developed responses and document the rationale for judgment calls so that they can calculate numbers consistently over time and properly address any future inquiries from the regulators. In recent remarks made at the ALI CLE 2012 Conference on Investment Adviser Regulation and published on the SEC's web site, the Director of the SEC's Division of Investment Management noted the importance of taking a reasonable approach and documenting it in the assumptions when responding to questions that seem unclear.
- *Implement controlled and replicable workflow processes*: To date, many first filers have relied on ad hoc manual processes, with inadequate controls and audit checks, to complete their Form PF filings. This approach tends to be very expensive in terms of staff time, is highly error-prone and can make it challenging to prepare subsequent filings every quarter. A sound and replicable process requires good workflow design that, for example, specifies which staff members and/or IT systems do what (and in what order); determines how assumptions for responses and judgment calls are decided upon and documented; and incorporates appropriate error checking and audit trails. Process controls (e.g., documenting work flows and requiring separate "makers" and "checkers") are also essential. After the process is specified, Form PF technology/software choices can be made to reduce the burden of manual work involved. Advisers that do not set up, internally and/or with external service providers, sound processes and infrastructure can expect to find it very challenging, time-consuming and expensive to prepare ongoing quarterly Form PF filings.
- *Take care in error checking*: Even the best of intentions and substantial internal efforts cannot eliminate the possibility of errors in a Form PF filing. It is therefore critical that an adviser provide for substantial error checking of interim drafts to reduce the odds of including incorrect information in its Form PF filing. Advisers should also plan to perform and evaluate test filings well in advance of the deadline.
- *Prepare for a new relationship with regulators and investors*: Form PF is one aspect of a broader secular trend towards heightened focus on hedge fund risk measurement and risk management by regulators and investors. Hedge fund advisers should anticipate continued growth in demands for risk information

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by various regulators, including the Financial Stability Oversight Council in the United States and financial regulators in other countries. For their part, institutional investors since 2008 have demanded substantially more transparency with regard to private funds' risk exposures and risk management processes. We believe these trends may force hedge fund advisers to go beyond simply reporting risk statistics to regulators and investors. In the not too distant future, we believe that hedge fund advisers may need to demonstrate that they have robust risk processes and controls and are "institutional-quality" in regards to risk management in order to attract and retain assets.

Tim Wilson co-heads the risk practice of Global Risk Management Advisors, a firm providing risk management services for alternative investment managers and institutional investors. Prior to joining GRMA, he served as Chief Risk Officer at Caxton Associates, headed Morgan Stanley's market risk function for Europe and Asia and served as an Economist at the Federal Reserve Board. He was founding chairman of the MFA's Chief Risk Officer Forum and is a member of the Editorial Board of the Journal of Risk Management in Financial Institutions.

Jonathan Miller is a partner in the New York office of Sidley Austin LLP. His principal practice areas include investment funds and advisers, corporate finance and securities regulation. Miller advises clients on securities regulatory matters, including Investment Advisers Act issues and filings. He also works on a wide variety of transactional matters, including structuring debt and preferred share offerings for investment funds, including hedge funds. Miller has been a frequent speaker at events on Form PF developments, for example, at the event covered in "Lessons Learned by Hedge Fund Managers from the August 2012 Initial Form PF Filing," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012).