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

www.hflawreport.com Volume 5, Number 38 October 4, 2012

Form PF

Operational, Investor and Regulatory Risk in Connection with Form PF: An Interview with Samuel K. Won of Global Risk Management Advisors

By Joe Story

The Hedge Fund Law Report recently had the privilege of discussing Form PF with Samuel K. Won, the Founder & Managing Director of Global Risk Management Advisors, Inc. (GRMA), a preeminent adviser to alternative investment managers and investors on risk management. GRMA has advised major hedge fund managers, institutional investors and regulators on preparation, filing and use of Form PF. In particular, the firm helped shepherd various "first filer" managers – generally, those with more than $5 billion in regulatory assets under management – though the Form PF process, and in doing so observed what first filers did right, and what they did wrong. That firsthand experience has direct bearing on how second and third filers should approach the Form PF process, and how first filers should revise their approaches for the second and subsequent filings.

In this interview, Won shared with The Hedge Fund Law Report some of the lessons learned (and not learned) from the August 2012 initial filing. In particular, Won addressed: the three major operational risks that first filer managers struggled with; the chief categories of risk associated with Form PF; how first filers can improve their infrastructure, processes and controls; what second and third filers should be doing to prepare for their initial Form PF filings; how regulators are likely to use the data obtained from Form PF; how institutional investors plan to use Form PF; allocation of expenses of Form PF preparation; who at a hedge fund manager should be the "point person" for the Form PF process; and more.

We conducted this interview with Won in connection with two upcoming events at which Won will participate, along with other panelists from Citi Prime Finance, Sidley Austin LLP and Imagine Software. Those events are entitled "Form PF: Lessons Learned and Not Learned from the August 2012 Initial Filing," and will expand on the topics discussed in this interview. The first of these two events will take place on Thursday, October 11 at the Princeton Club in Manhattan from 4:00 p.m. to 7:30 p.m. The second of the two events (covering substantially similar substance) will take place on Thursday, October 18 at l'escale Restaurant at the Delamar Greenwich Harbor Hotel in Greenwich, Connecticut from 4:00 p.m. to 7:30 p.m. Registration for both events is free. To register for the New York event, click here. To register for the Greenwich event, click here.

HFLR: Can you briefly describe your experience as it relates to Form PF

Won: GRMA has been actively involved advising major fund managers, institutional investors and regulators on Form PF. From our recent experience with "first filer" funds, we observed that many fund managers significantly underestimated both the work and time involved in completing their first filing. We found that a large number of first filers relied upon a largely manual process that is not repeatable or sustainable.

HFLR: What were the major operational challenges that

hedge fund managers faced in preparing for, completing and making their initial Form PF filings?

Won: There were three major operational challenges that we found that most first filer hedge fund managers struggled with while completing their initial filings.

First, we found that almost all filers struggled with how to answer many of the questions in Form PF because the questions are vague and/or ambiguous. Furthermore, these filers were not certain of what the regulators were looking for in many of the questions on Form PF. In particular, we found that first filers struggled with developing appropriate assumptions and risk methodologies for the questions in Section 2 of the Form.

Second, we found that fund managers were overwhelmed by all of the data from disparate sources that they needed to aggregate in order to answer Form PF questions. Along these lines, there was a common misconception among many funds that their administrators had most or all of the data necessary to complete Form PF. What these funds soon discovered was that their administrators had only some of the data and could only satisfy a portion of a fund's data needs around Form PF.

Third, we found that because most funds employed a largely manual Form PF process and had no well-defined Form PF workflows or associated controls, they worked feverishly until the last minute to prepare their initial filings, with senior management spending excessive amounts of time working directly on the filing.

HFLR: Based on your experience, what are the three or four chief categories of risk associated with Form PF of which hedge fund managers are unaware or insufficiently aware?

Won: Because many first filers were so focused on completing their initial filing in whatever manner they could, they did not fully consider the many risks associated with Form PF. There are several major categories of risk that Form PF filers were unaware of and did not fully take into account as they completed and submitted their filings:

- Operational Risk – risks associated with errors in a fund's filing caused by having manual processes and lack of proper controls for Form PF.
- Investor Risk – risks that may arise because investors, using Form PF as a "window on risk," may see that their fund managers have weak or non-existent risk management in place.
- Legal/Regulatory Risk – risks that may arise from inconsistencies among a fund's Form PF filing and what it represents in its Due Diligence Questionnaires (DDQs), other marketing materials, legal documents and investor communications. Includes risks that may be triggered by "red flags" in a fund's Form PF filing, such as incorrect or deliberate misrepresentations made by a fund about its risk profile.

HFLR: Briefly, what (or who) are "first filers," and what (or who) are "second filers" and "third filers"?

Won: For hedge funds, the essential "dividing line" between "first filers," "second filers" and "third filers" is based largely upon a fund's regulatory assets under management (RAUM), defined in the same manner as for Form ADV. Specifically, first filer hedge funds are those with at least $5 billion in

RAUM, second filers are those that have between $1.5 billion and $5 billion in RAUM and third filers are those that have between $150 million and $1.5 billion in RAUM. Funds below $150 million in RAUM do not have to file Form PF.

HFLR: What should first filers be doing to improve their infrastructure, processes and controls for their next Form PF filings and subsequent filings?

Won: Given that most first filers used a largely manual process for completing and submitting their Form PF, we strongly believe that a fund should put in place the following: well-defined workflows and controls/audit trails; more automation for data aggregation and normalization; proper data infrastructure for storing data and Form PF filings (e.g., a data warehouse); and an independent pre-submission review and check of their Form PF.

HFLR: What should second filers and third filers be doing to best prepare for their initial Form PF filings, and when are their initial filings due?

Won: Second filers and third filers would be wise to leverage some of the "lessons learned" by first filers. In particular, they should start work on Form PF as soon as possible. We believe it is crucial for second filers and third filers to put in place well-defined workflows, automation and proper audit trails and other controls to ensure that they have a sound process that is repeatable and sustainable.

Second filers must submit their initial Form PF filings on March 1, 2013 with data from year-end 2012. Third filers must submit their initial Form PF filings on April 30, 2013 with data from year-end 2012.

HFLR: How are regulators likely to use the data obtained from Forms PF filed by hedge fund managers?

Won: The original intent for Form PF was for the regulators to assess the contribution of private funds to systemic risk – and this is still an important objective for the regulators. However, during our discussions with the regulators, they made it clear that Form PF will also be used for fund-specific examination and enforcement. We believe that one of the principal focus areas of examination and enforcement will be to assess how accurately a fund's Form PF filing portrays its risk profile and whether this portrayal is consistent with what it tells investors. In the long run, we believe Form PF risk reporting is the first step towards broader risk-based regulation of private funds such as hedge fund and private equity firms.

HFLR: How do institutional investors plan to approach, access or use Form PF?

Won: We have advised a number of major institutional investors with regards to Form PF. We believe many institutional investors will ask their fund managers to either disclose much of the information in a fund's Form PF or the Form in its entirety. Given the secular trend toward greater hedge fund transparency, especially with regards to risk management (e.g., the Opera initiative), we believe that it is a fait accompli that funds will soon have to provide much or all of the information in Form PF to their investors.

We believe institutional investors will use the information in Form PF in a number of ways, including due diligence, monitoring and aggregating the investment risks of their fund investments and as legal recourse should they discover that a fund manager was not truthful in representing its risk profile.

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

www.hflawreport.com Volume 5, Number 38 October 4, 2012

HFLR: What are you seeing with respect to the allocation of expenses of Form PF preparation, completion and filing between hedge fund managers and their funds?

Won: Thus far, we have seen no clear consensus on allocating Form PF expenses. We have observed that some funds plan to charge back some or all of their Form PF expenses to the fund while others view it as an expense that should be borne by the management company.

HFLR: What are the most common mistakes you have seen hedge fund managers make in preparing for, completing and filing Form PF?

Won: One of the most common mistakes that we have seen is that a large number of funds have incorrectly treated Form PF as simply a data aggregation and "fill-in-the-blank" exercise or have treated the Form as a "work in progress" because they believe that regulators will not be able to review their filing in any depth. We believe that this kind of arrogance is very risky and significantly underestimates the potential downside risks with regulators and investors of submitting an inaccurate or incomplete filing.

A second common mistake is that many funds believe that they can simply rely upon their administrator's Form PF services or license some software in order to complete their Form PF. Administrators and Form PF software providers can play a useful role in the Form PF process. These firms can help a fund to populate data onto the form and create the final XML upload file once a fund has done the "heavy lifting" of deciding upon assumptions and risk methodologies and has developed answers for Form PF questions. However, administrators and Form PF software providers are not subject matter experts in regulatory matters such as Form PF or in risk management more generally – we cannot emphasize enough that these service providers can only offer a partial solution for Form PF.

HFLR: Are firms having difficulty obtaining certain types of information required to complete Form PF? If so, which kinds of information are they having trouble obtaining, and how are they addressing this difficulty?

Won: Funds are having difficulty pulling together all of the data from the various disparate sources that are needed to prepare Form PF (e.g., primes, administrators, risk analytics vendors, internal spreadsheets, data warehouse, accounting systems, etc.). We have found that funds are struggling most with interpreting the questions and determining what the regulators intended and are looking for as correct answers, reasonable assumptions and valid risk methodologies for Form PF's questions.

HFLR: Who at a hedge fund manager is best suited to be the point person to coordinate the Form PF preparation, completion and filing process?

Won: Typically, we have observed that the point person for Form PF at most funds is either the Chief Operating Officer, Chief Financial Officer, General Counsel or Chief Compliance Officer. We believe that it makes sense for a fund to have a Form PF Committee that is comprised of representatives from Finance, Operations, Legal, Compliance and Risk. Having a Form PF Committee best ensures that there is a coordinated effort to preparing, completing and submitting a fund's Form PF filing. This Committee should be responsible for ensuring that a fund has the proper infrastructure, processes and controls for a sound, sustainable and repeatable Form PF program.