

## SEC's Form PF: Meeting the Data Challenge

Form PF: It's the brand new form the Securities and Exchange Commission wants hedge fund, private equity fund and liquidity fund advisers to fill out so the U.S. government can keep track of systemic risk.

It wants to avoid another major hedge fund collapse. Hint: the demise of Long-Term Capital Management. The fund, which closed its doors in 2000, relied on complex mathematical models to take advantage of fixed-income arbitrage deals usually with U.S., Japanese and European bonds. In European government bonds. In 1998 it lost a whopping \$4.6 billion in less than four months requiring the Federal Reserve Bank to intervene.

But there is a second reason which has fund managers pretty scared: the SEC also said it wants to sniff out potential fraud. Hint : the Madoff scandal where Bernie Madoff was able to pass off pretty shady and inflated performance figures to investors still embroiled in legal disputes over who will make them whole.

The good news: the SEC has extended the deadlines for hedge fund, private equity and liquidity fund managers to file Form PF. It's a few months away at the earliest, but that's still no reason to procrastinate. Based on the tons of data the SEC wants from some advisers, consultants and service providers are warning fund managers to quickly come up with a gameplan for finding and collecting that data fast. If they don't, they could face a potential audit at best. At worse, financial penalties and even closure.

"Fund managers will need to determine whether they must file form PF with the SEC, what types of private funds they manage, their assets under management in those funds; what data is required; who will find the data and how it will all be aggregated," says Dan Reid, director at global consultancy KPMG in New York. "It could take as little as two months to as long as ten months to get ready."

The cost will also vary. No one wants to speculate just how much, but \$100,000 was cited by several large hedge fund managers contacted by ISS Mag.com's online edition. The ultimate pricetage will vary based on the size and type of the fund and just how solid its data management structure really is. A large hedge fund will find it a lot harder to fill out the form than a private equity fund.

The amount of information that advisers must provide the SEC, the frequency of reporting and when they must file all depends on the value of the adviser's regulatory assets under management and the type of fund involved. For starters, a fund adviser must be managing at least \$150 million in so called "regulatory assets" in private funds to file Form PF. Large hedge fund advisers must file quarterly within 60 days at the end of each quarter while large liquidity fund advisers must file 15 days at the end of each quarter and large private equity advisers must file within 120 days at the end of each fiscal year. Smaller private equity fund advisers must also file within 120 days at the end of each fiscal year.

Large hedge fund advisers are defined as those having at least \$1.5 billion in regulatory assets attributable to hedge funds while large liquidity fund advisers -- those managing a liquidity fund-- must have at least \$1 billion in regulatory assets under management attributable to liquidity funds and large private equity fund advisers must have at least \$2 billion in regulatory assets under management attributable to private equity funds.

First up to file: the largest hedge fund advisers- those with at least \$ 5 billion in hedge fund assets will be required to file their form PF with the SEC within 60 days of June 30- September 1. Liquidity funds with about \$5 billion in assets will have to file at about June 30- 15 days after June 15 while private equity funds with at least \$5 billion in assets as of June 30 will have to file within 120 days. Most hedge fund advisers will likely not be required to file until April 2013.

"Calculating regulatory assets under management is specifically defined and not exactly the same as calculating assets under management," say Kevin Duffy, a director at consultancy Kinetic Partners in New York. The SEC wants the figure to be based on aggregate long and short positions as well as swap positions. "It could require firms to look up the terms of their swap contracts with counterparties to determine how they will account for their retained and notional values." Swap contracts based on convertible bonds, commonly known as ascots, could be a sore spot. At

issue is whether form PF will require the fund to include and record the value of positions of ascots as straight bond instruments or a converted bond to equity position which could force an adviser to include a higher value for the contract even if it has no intention of converting the position to equity.

Many fund advisers will likely need to complete only section 1 of form PF which provides basic descriptive information about their funds such as their value, performance and use of leverage. The larger ones will likely have to file three additional sections to provide information about the counterparty risk, liquidity, leverage and performance for each of the funds they manage with over \$500 million in value. That information must also be rolled up into a single figure for the entire suite of funds under their umbrella.

It shouldn't sound that difficult considering the technological sophistication of hedge funds in making money on complex trading strategies. But the reality is far different. "Smaller hedge funds will have limited staff to throw at compliance while larger ones will have to find the data in disparate locations and formats," says Marshall Saffer, chief operating officer for MIK Fund Solutions, a New York-based firm specializing in hedge fund software.

Just where does all that information reside? "It will likely end up being at the adviser, prime broker, custodian and fund administrators depending on the type of information," says Reid. "Fund advisers will need to map just who has the information and whether it is reliable enough to include in a filing made with the SEC."

Hopefully, the information will be held in electronic form but that might not always be the case. "There are some fund managers who are holding information about their swap positions on paper," says Duffy.

Once fund managers figure out just where the information is located, they have to determine just who will be involved in collecting the data. "While the chief operating officer or chief compliance officer could well end up owning the task of completing form PF, separate tasks could fall on investor relations, risk management and compliance departments," says Phil Niles, director of product development for Butterfield Fulcrum, a fund administrator headquartered in Bermuda. "Representatives of the prime broker and fund administrator could also be called upon to provide guidance or assist in the data gathering process."

Bringing in a third party consultant to manage the entire process might not be such a bad idea. "It's an extremely time consuming effort and C-level executives don't exactly have time to spare mapping out all of the data requirements, where it is located and who is responsible for what portion of the data," says Gary Kaminsky, principal leading regulatory enterprise risk management advisory services in New York for Rothstein Kass, an accounting and consulting firm specializing in alternative investment funds.

As is the case with many regulatory initiatives, technology could also go a long way: a centralized data warehouse to aggregate and store all of the information including an audit trail of where it came from. "Fund managers which already have a central data warehouse are integrating it into the applications needed to access the data for Form PF," says at Martin Saffer, a MFK Solutions.

But even that may not be a panacea. For one, the underlying presumption is that all of the data will be accurate. That's likely the case if the fund manager has already reconciled data with the prime broker and fund administrator. One mistake could easily result in a miscalculation of liquidity, market risk or counterparty exposure.

Yet another solution: dumping all the work on the fund administrator. It may sound ideal, but still not work. "The fund administrator may not have all of the necessary data if it isn't the sole administrator," says Reid. Even if they do at best it is unlikely they will want to assume legal liability for any errors. That leaves the fund manager at square one: either doing all the work itself or doublechecking all of the work done by the fund administrator.

Making compliance mindboggling for some large advisers. there is some room for interpretation. One instance, says Niles: measuring portfolio liquidity. The SEC wants advisers to estimate the timeline required to liquidate their portfolios; market circumstances beyond the control or estimation of the advisers could have a huge impact on the liquidity of the portfolio. Therefore, assumptions must be made. Among the market circumstances: terrorist attacks such as 9/11 and natural disasters.

Yet another scenario: forecasting the impact of certain market events on a portfolio. To do so, an adviser must first determine whether or not a factor is even relevant, then what impact each would have depending on the degree of change; common changes include changes in interest rates and swap spreads.

"As we have seen over the past few years, markets can become correlated in unexpected ways during times of stress," says Niles. "While past experiences can offer assistance in making such predictions, the random nature of markets means this section of form PF could generate different results depending on the viewpoint of the investment manager."

At the very least, advisers can eliminate some common and easy to prevent mistakes will generate a dreaded SEC audit. Although the SEC may have limited resources to actually sift through each and every Form PF it says it will pay

the closest attention to inconsistencies. Answers must match up between Form PF, Form ADV and due diligence questionnaires. That's the mindboggling series of questions which institutional investors often ask a hedge fund before investing. "The SEC won't hesitate to ask for every piece of information and figures have to match up," says Kaminsky.

While each document that a firm provides its constituents may have different purposes. There is an overlap in the data reported. Form ADV is the core registration document that all registered investment advisers need to file with the SEC that contains information concerning the size of the firm, its principals, business strategy and investor base. It is designed to provide the SEC and the public with basic information concerning registered firms. Form PF is primarily designed to assist the FSOC, a newly created government multi-agency organization in assessing the systemic risk of the alternative management industry."

Two potential red flags: wildly different value of assets under management and performance figures. "You can't provide the SEC one figure of value and performance and investors another," says Kaminsky. Yet another sniff test: performance returns which don't make sense. "If the fund managers return is 150 percent and the same index for a fund's strategy is 15 percent something is amiss," says Kaminsky.

There is one silver lining for advisers who don't view filing out form PF strictly as a tedious compliance exercise. "It could prove to be a valuable opportunity for firms to shore up their enterprise risk management systems and facilitate their process for reporting of information to all constituents," says Kaminsky. "Firms should use the exercise to create a central data warehouse that can be drawn for all disclosure documents."

Doing so, says Kaminsky, will ultimately enable them to ensure that data flows consistently and accurately among the front, middle and back offices and between the firm and third-party service providers. The result: firms can reduce their risk for non-compliance, operational lapses and incorrect disclosures.