ADVANCED TRADING

Form PF Will Be a Painful Burden for Hedge Funds

The new Form PF regulatory reporting requirements represent a landmark shift for the traditionally secretive hedge fund industry, and they'll come with a hefty price tag.

The new reporting requirements that hedge funds face under the Dodd-Frank Act represent more than the typical back-office headache for the industry. They're more like the operational equivalent of a colonoscopy for a sector that traditionally has preferred to keep intimate details about its business — such as investor liquidity or details of counterparty exposures — under wraps.

Under Dodd-Frank, hedge funds and other private fund advisers that manage $150 million in assets or more will have to fill out Form PF, the brainchild of regulators who are looking to prevent seismic events like the demise of Long-Term Capital Management, which in 1998 lost $4.6 billion in a matter of months before the Federal Reserve was forced to step in and stop the bleeding. Most hedge funds will begin filling out the form in December 2012, though funds with $5 billion in assets under management (AUM) or more will begin doing so in June. The data that's collected will be used by the Financial Stability Oversight Council to monitor overall risks to the U.S. financial system.

Under Form PF, regulators will conduct stress tests on managers' portfolios, searching for answers to questions such as how a firm would be impacted by a 10 percent plunge in the S&P 500. The data will be used to get a sense of a hedge fund's investment positions and the types of assets it holds, and to delve into a firm's trading practices.

"They want to know not so much what the investment manager is trading, but to what scale they're trading," says Phil Niles, the director of product development at Butterfield Fulcrum, an administrator for alternative investment firms. "Do they pose a sort of systemic risk, whether in one segment of the market or for the markets as a whole?"

No Trivial Pursuit

As regulators prepare to take in the mountainous volumes of data that hedge funds will produce, funds are busy making sure their operations are even capable of correctly compiling the data. "There are questions that are just too involved for anybody to extract that data from any source trivially — like, 'What's your convexity and duration in your bond portfolio?'" says George Michaels, founder and CEO of tax compliance software provider G2 FinTech. "How are you going to calculate that?"

Since the effort to capture much of the necessary data will be unprecedented in scope, hedge funds will need to approach Form PF reporting not just as a mere document to be filled out, but rather as an entirely new process, Butterfield Fulcrum's Niles adds. "The degree of information that regulatory bodies are looking for coming out of Form PF is pretty onerous," he says. "Internally they're going to have to find the bandwidth to actually complete it. The process of filling out Form PF is pretty extensive and not something you can kind of sit down in a weekend and put together."

Even to complete a single Form PF report, a hedge fund will need to fill out 440 data points across 14 categories, according to hedge fund administrator GlobeOp, which launched a Form PF reporting service this past summer. And the bigger the hedge fund, the more sections it'll need to fill out.

G2's Michaels argues that the process to compile the necessary data will be so demanding — particularly for large hedge funds — that they'll have no choice but to beef up manpower within their internal compliance departments and through the hiring of outside consultants. And adding more staff is something hedge funds generally loathe doing, he notes.

"Any large hedge fund has to do the long form, all of which takes tremendous time and analysis," Michaels explains. "They're time- consuming and, yes, their portfolio managers could probably figure out how to do it themselves. But the numbers they'll have to commit will dramatically pull away from their day jobs — which is trading their clients' money."

There's No Silver Bullet

In order to complete Form PF, chief compliance officers at hedge funds have a number of choices, industry sources say. They can bring in consultants to do it, hire more staff, outsource to a firm such as Deloitte & Touche, or turn to services provided by companies such as Butterfield Fulcrum and GlobeOp.

Michaels says G2, which used to provide software and consulting services to the alternative investment community before changing its focus in 2011 to tax analysis and regulatory compliance software, would have charged a large hedge fund around $300,000 a year for this sort of work. He estimates brand-name advisory firms like KPMG or Deloitte & Touche would probably charge two or three times that.

Cheaper technology solutions that can help streamline the data collection process also are likely to pop up, though their price tag could be fairly steep, as well, according to Butterfield Fulcrum's Niles. "When you look at the alternative cost as far as the investment manager having to staff out a larger compliance or regulatory piece of their organization — the costs there are quite substantial," Niles cautions. "This is an expensive process, and whether it's done through human intervention or some sort of technology tool, it's not going to be cheap."

Since the process will be expensive, G2's Michaels says, vendors will dangle cheaper solutions that they claim will be able to automate the process, basically making the problem disappear for a small fee. But you get what you pay for, he warns, and firms that look to cut corners could be burned in the long run.

"There are plenty of fly-by-nights who'll say, 'Give me $2,000 and I'll make your Form PF go away,'" Michaels says. "There are vendors telling you there's a silver bullet because the hedge funds really want there to be a cheap solution. But there isn't one."