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THE SEC'S FORM PF: ORSA FOR HEDGE FUNDS

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Hedge funds have long enjoyed being one of the least regulated sectors of the financial service industry. However, SEC/CFTC rules adopted in late 2011 pursuant to Dodd-Frank have brought significant risk-related regulation to large hedge fund managers. Beginning with 2012 second-quarter end-data, the very largest hedge fund managers (over $5 billion in regulatory assets under management—RAUM) will need to file a new form each quarter, Form PF, which requires a large volume of information including exposures, counterparty risk, liquidity risk, durations, market risk factor sensitivities, and other risk measures, potentially including value at risk. Managers with RAUM of $1.5 billion will need to begin to file this form quarterly beginning with year-end 2012 data. Managers with $150 million or more will have to file Form PF annually beginning with year-end 2012, but are not required to file the same degree of risk-related information.

Conceptually, Form PF bears a resemblance to insurers' Own Risk and Solvency Assessment (ORSA) in that certain assumptions and calculations are left to the filing entity. For example, fund managers are allowed to use their own assumptions and own models for calculating VaR and other risk measures. In fact, if a fund does not calculate VaR regularly, then it doesn't need to be calculated for the filing. There is similar leeway in the filing instructions for the calculation of sensitivities to pre-specified shocks to market risk factors (The factors are equity prices, the risk-free interest rate, credit spreads, currency rates, commodity prices, implied option volatilities, and default rates for ABS, corporates and CDS.).

However, while there is leeway, there is also a catch-all for risk measures. The fund must include any risk measures that it reports either internally or to its investors. And some risk measures are definitely required, particularly durations (or alternatively, weighted average tenor or 10-year bond equivalents), segmented into 22 specified asset classes, for both longs and shorts, calculated for each month-end. The duration calculations apply to the aggregated funds managed as well as specific funds.

Form PF also applies to private equity funds and so-called liquidity funds, however, the risk-related requirements are not nearly as extensive as those described above.

A LOT OF DEVIL IN THE DETAILS

It's fair to say that the speed of adoption and breadth of information required by Form PF have come as a surprise to many managers. Many fund managers are unprepared and do not realize the extent of the calculations required for Form PF. There are also some critical details that serve to widen the scope of the reporting while also making certain risk requirements quite granular.

- The threshold for filing Form PF is regulatory assets under management, which is essentially equal to gross GAAP assets. Managers and the industry, though, typically think of their fund size in terms of net assets, i.e., long positions net of short positions. There are funds with less than $1 billion in net assets that leverage up to well over the $5 billion in RAUM threshold for early filers.

- Some of Form PF's requirements are for the aggregate of funds managed, but some measures, especially the risk requirements described above, must be applied at the individual fund level. So while some observers simplistically characterize the regulation as data aggregation, it is actually a mix of aggregation, disaggregation, and then re-aggregation into specified buckets—but with some complex risk calculations sprinkled throughout these processes. Many compliance professionals do not have the background to appreciate the complexity imposed by the risk calculations.

- The requirement that any risk measure reported internally or to investors must be included in the filing

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creates a catch-all requirement for which the SEC at this writing has yet to provide definitive details. Distinguishing risk measures from portfolio valuation and asset selections tools is subjective. For example, are CAPM parameters risk metrics? Greeks? Fundamentals like price-to-book value or price-to-earnings? Technical analyses?

- While the use of VaR and other risk measures reported internally or to investors certainly captures the spirit of using one's own risk assessment, it certainly falls short of the insistence on VaR-based approaches that is present in other financial services regulation, e.g., Basel Accords, Solvency II, RBC C-3 Phase II, etc.

LOOKING AHEAD

On a different level, this regulation is a watershed event. Up until now hedge funds have been left completely to their own devices regarding risk. Standardization of hedge fund risk has now begun and it is likely that fund investors, potential investors, and intermediaries will soon be tailoring their risk inquiries to include Form PF data. Even though funds are under no obligation to disclose the information other than to the regulators, market pressure likely will force at least some of this data to be released. There are already private sector initiatives to accomplish exactly this on a voluntary basis, such as OPERA (Open Protocol Enabling Risk Aggregation).

Investors will find this information useful in several respects when assessing a fund.

1. What types of risk is the fund willing to undertake, e.g., long-short duration mismatch, market factor risk, concentrations with respect to asset class, geography, counterparties, or illiquid assets?
2. How levered is the fund?
3. What type of off-strategy investments does the fund typically hold?
4. What does the time series data for the fund's risk measures indicate about how, and how often, the fund changes its risk preference?
5. What type of tail risk does the fund's strategy create?

Of course, hedge funds are not always enthusiastic about answering questions such as these, far less so with the specificity Form PF requires. Fund managers often feel that standard metrics do not properly reflect the way in which they make investments decisions and, in any case, they do not wish to make it easier for anyone to reverse-engineer their strategies.

However, what these newly-risk-regulated fund managers may only be beginning to appreciate is that questions like those above are not simply due diligence questions, but are of interest to investors in aggregating their own investment risks for their own governance and regulatory purposes. The very existence of this data virtually assures that many institutional investors will make it a condition of their investing to receive the information in some form. This in turn may cause funds to consider how their investment strategies will play out in Form PF.

As a result, Form PF and additional measures that may follow from financial reform will probably have the effect of shaping risk in addition to reporting on it, much in the way Solvency II and IFRS (and U.S. analogs of these) will shape insurance company product offerings and investment strategies.

While Form PF can be compared to ORSA conceptually in terms of risk disclosure, the comparison falls short with respect to solvency. Measures suggestive of tail risk and the possibility of systemic risk are certainly included, but there is no solvency standard, per se. Rather, solvency is only covered implicitly in the collateral and margin requirements that underlie the fund's holdings.

“STANDARDIZATION OF HEDGE FUND RISK HAS NOW BEGUN. … ”

How much more is to come? There are estimates that Dodd-Frank ultimately will spawn 400 rules, only about a quarter of which have been promulgated to date. Not all of these expected rules will affect hedge funds directly, though many will certainly have an indirect impact through the effects on other financial institutions which invest in hedge funds. But certainly, the early shock waves have been significant for fund managers.

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