



## VALUATION & FINANCIAL RISK MANAGEMENT

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#### About Navigant

Navigant, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the Firm primarily serves clients in the healthcare, energy and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at [navigant.com](http://navigant.com).

# RISK REPORTING IN THE DODD-FRANK ERA: FORM PF

One of the many outcomes of the Dodd-Frank Wall Street Reform and Consumer Protection Act is Form PF, a sixty-three-page document that the SEC finalized in October 2011 along with a number of rules governing its application and implementation. The SEC created Form PF in order to understand and measure the risk in the financial system more accurately and more timely so that future crises to the system could be averted. In an effort to shed light on the sometimes cavernous world of private funds, including private hedge funds<sup>1</sup>, private equity funds<sup>2</sup>, and private liquidity funds<sup>3</sup>, regulators now require private fund advisers with assets under management that exceed specific thresholds to report an abundance of information, such as:

- A breakdown of assets by fund type,
- The fund's borrowings and creditors,
- The fair value of Level 1, 2, and 3 assets and liabilities,
- Counterparty exposure, and
- The duration and fair value of all fixed income holdings, among other items.

Regulators believe that the strategic and operational information reported on Form PF will aid the SEC and the Financial Stability Oversight Council (FSOC) in assessing systemic risk. Important to note is that all information reported will remain confidential and available only to regulators.

## IMPLEMENTATION REQUIREMENTS

Deadlines for the implementation of Form PF reporting and requirements that relate to the frequency of reporting vary based on the size and type of fund. "Large advisers" to hedge funds and liquidity funds must file Form PF on a quarterly basis within 60 days and 15 days of the adviser's fiscal quarter-end, respectively. "Large advisers" to private equity funds must file annually within 120 days of the adviser's fiscal year-end. For the purposes of Form PF reporting, hedge fund advisers with assets under management (AUM) of at least \$1.5 billion, liquidity fund advisers with AUM of at least \$1 billion, and private equity fund advisers with AUM of at least \$2 billion are classified as "large

1/ As defined by Form PF, "hedge funds" are any private funds other than securitized asset funds that pay performance fees to the advisers based on unrealized gains (i.e. market value), may borrow an amount in excess of one-half of its NAV or may have gross notional exposure in excess of twice its NAV, or may sell securities or other assets short or enter into similar transactions other than for the purpose of hedging currency exposure or managing duration.

2/ As defined by Form PF, "private equity funds" are private funds that are not hedge funds, liquidity funds, real estate funds, securitized asset funds, or venture capital funds and do not provide investors with redemption rights in the ordinary course.

3/ As defined by Form PF, "liquidity funds" are any private funds that seek to generate income by investing in a portfolio of short-term obligations in order to maintain a stable NAV per unit or to minimize principal volatility for investors.

advisers". All other advisers with at least \$150 million in AUM must file Form PF annually within 120 days of the adviser's fiscal year-end.

All advisers with AUM of at least \$5 billion must begin filing Form PF with the first fiscal quarter- or year-end that falls on or after June 15, 2012. Advisers with AUM between \$150 million and \$5 billion must begin filing with the first fiscal quarter- or year-end that falls on or after December 15, 2012.

Like the frequency and timing of reporting requirements, the complexity and quantity of information that must be reported on Form PF vary with the size and type of fund, with "large advisers" being subject to greater transparency than their smaller counterparts. Form PF is comprised of the five sections set forth in the following table, which delineates the areas of responsibility for the entities that must file Form PF:

SECTION	REQUIRED TO COMPLETE	CONTENT
Section 1	All Form PF filers	Section 1a <ul style="list-style-type: none"> <li>Identifying information for the advisor</li> <li>Breakdown of regulatory and net AUM</li> </ul>
		Section 1b <ul style="list-style-type: none"> <li>Identifying information for every private fund advised by the advisor</li> <li>Gross and net asset value</li> <li>Value of investments in equity of other private funds</li> <li>Value of borrowings and types of creditors</li> <li>Value of derivative positions</li> <li>Fair value of Level 1,2, and 3 assets and liabilities</li> <li>Investor ownership of the fund's equity</li> <li>Monthly and quarterly gross and net performance</li> </ul>
		Section 1c <ul style="list-style-type: none"> <li>Identifying information for every hedge fund advised by the adviser</li> <li>Percentage of fund's NAV attributable to various investment strategies</li> <li>The 5 counterparties to which fund has greatest MTM counterparty credit exposure</li> <li>Breakdown of securities traded over an exchange vs. OTC</li> </ul>
Section 2	Large hedge fund advisers	Section 2a <ul style="list-style-type: none"> <li>Aggregate long and short exposures by asset class for each month in the reporting period</li> <li>Value of turnover in each asset class for each month in the reporting period</li> <li>Geographic breakdown of investments and value of investments in BRIC countries, Japan, and US</li> </ul>
		Section 2b <ul style="list-style-type: none"> <li>Aggregate long and short exposures by asset class for each month in the reporting period for each qualifying hedge fund advised by the advisor</li> <li>Liquidity profile of the reporting fund's portfolio</li> <li>Value of fund's unencumbered cash for each month in the reporting period</li> <li>Percentage of fund's NAV attributable to open positions that represent 5% or more of fund's NAV for each month in the reporting period</li> <li>Value of collateral posted in the form of cash, securities, and other collateral by each of top 5 counterparties</li> <li>Value of collateral posted by the fund in the form of cash, securities, and other collateral to each of top 5 counterparties</li> <li>VaR calculation methodology and VaR for each month in the reporting period</li> <li>Impact of changes in various market variables on portfolio</li> <li>Value of borrowing, types of creditors, and collateral posted for each month in the reporting period</li> <li>Value of all derivative positions</li> </ul>

SECTION	REQUIRED TO COMPLETE	CONTENT
Section 3	Large liquidity fund advisers	Section 3 <ul style="list-style-type: none"> <li>Identifying information for liquidity funds advised by the adviser</li> <li>Compliance with provisions of rule 2a-7</li> <li>NAV, NAV per share, WAM, WAL, and 7-day gross yield in each month of the reporting period</li> <li>Value of positions with exposure to selected products by maturity</li> <li>Percentage of fund's NAV attributable to open positions that represent 5% or more of fund's NAV for each month in the reporting period</li> </ul>
Section 4	Large private equity advisers	Section 4 <ul style="list-style-type: none"> <li>Identifying information for private equity funds advised by the adviser</li> <li>Weighted average, highest, and lowest debt-to-equity ratio for portfolio companies in which fund invests</li> <li>Gross asset value, total principal amount of borrowings classified as current liabilities, and total amount of borrowings classified as long-term liabilities of portfolio companies in which fund invests</li> <li>Percentage or portfolio companies' borrowings that are PIK or zero coupon debt</li> <li>Occurrences of event of default on the part of the fund or its portfolio companies</li> <li>Bridge loans or commitments for bridge loans to portfolio companies</li> <li>Debt-to-equity ratios and gross asset value of financial industry portfolio companies and the fund's percentage of gross assets invested in these companies</li> <li>Breakdown of investments in portfolio companies by industry and geography</li> <li>Gross value of investments in portfolio companies located in BRIC countries, Japan, and US</li> </ul>
Section 5	Advisers requesting a temporary hardship exemption	Section 5 <ul style="list-style-type: none"> <li>Nature of temporary technical difficulties and reasons for requesting exemption</li> </ul>

## IMPLEMENTATION CHALLENGES

The filing of Form PF puts significant pressure on an institution's data gathering and reporting operations. Non-bank private financial companies historically have not been subject to the transparency required by Form PF, so many of these firms either lack the infrastructure necessary to complete portions of the form or would like to revisit the infrastructure and methodologies already in place in order to best represent the adviser's operations and controls to the SEC.

In particular, investors in distressed assets may find the completion of Form PF challenging as specific areas of the document request the adviser's fair value representation of Level 1, 2, and 3 assets (item 14) and others require that the fund's positions be tested under a variety of stress scenarios in which

only one market variable is stressed in each scenario (item 42). Isolating the impact of a change in one market variable may be difficult for investors in complex securities whose values depend on market variables that may be interrelated.

Form PF filing will require the allocation of considerable resources to collect, calculate, store, and report relevant information. Large private fund advisers face significant reporting burdens from the requirement of reporting geographic, market, credit, and liquidity risks that they assume. Compliance efforts will also require continuous and constructive dialogue between outside counsel, accountants, and the regulators. Meeting the reporting deadlines and complying with periodic reporting will require considerable planning, process implementation and automation.

The Form PF requirements will significantly reshape systemic risk assessments in general and the business processes of private fund advisers in particular. Similar to Sarbanes-Oxley, the Form PF regulation will impact the private fund adviser market by forcing changes to the overall operational landscape, from data gathering to modeling and reporting. Transparency becomes the key operative. It is important to realize that the information disclosed on Form PF will be used in a variety of ways: regulators intend to use information in examinations, investigations, and potential enforcements; certain information will be used by institutional investors for due diligence as well as optimal investment decisions. This potential use of information elevates the need to be accurate, complete, and transparent. Ascertaining data quality and integrity, rigorous validation of valuation methodologies and adherence to accounting principles become an integral part of operational assessments.

## IMPACT OF FORM PF

Given the volume of information required and the short time frame, firms should evaluate the current state of technology and operational infrastructure and compare the capabilities of the current state to their inventory of Form PF requirements.

Here are some of the items advisers might find useful:

- Determine which sections of Form PF are relevant
- Determine the data elements required for the firm
- Determine where each data point resides within or outside the firm
- Determine the process of capturing those data points
- Create a process for aggregating the data
- Evaluate how to automate and accelerate the process



## WHY NAVIGANT

Navigant's risk management professionals bring deep expertise in credit risk, market risk, and operations risk. Years of experience in working on regulatory challenges going back to SOX compliance make us an effective partner in addressing Form PF compliance. Our risk management service offerings include:

- Data Quality and Integrity
- Credit, Market, and Operations Risk Management
- Pricing and Valuation (all asset classes)
- Model Risk Management
- Reporting Automation
- Regulatory Compliance
- Finance Process Reengineering
- Internal Audit Support