



Hedge fund advisers face a regulatory landscape populated by tight deadlines. Unfortunately, the rules they need to implement still require much clarification.

Tight Deadlines with Plenty of Uncertainty

By Kathryn Tully Summer is usually a time to relax and take a vacation, but not so if you are involved in regulatory compliance at a major hedge fund. Deadlines for hedge fund advisers to comply with new US regulations are coming thick and fast. In fact, the deadline already has come and gone for the first hedge funds to file Form PF, the enormous document including around 50 questions and requiring 2,000 data points that the SEC is demanding from newly registered funds under the terms of the Dodd-Frank Act. *(continued on next page)*

Fund advisers with more than \$5 billion in regulatory assets under management had to file their Form PF by August 29, while the next wave, with \$1.5 billion in assets under management, will have to file by the end of February 2013. Both groups must subsequently file a Form



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PF every quarter. All other hedge fund advisers, with more than \$150 million in regulatory assets under management, will have to file Form PF annually, starting at the end of next April.

Auditors and accountants are already reporting technical glitches that prevent some of the Form PF data from the first wave of filers from being converted into XML, the format required by the SEC. But there are still much larger areas of uncertainty, even after the first filers have submitted their documents. "One of the biggest issues with Form PF is that the SEC hasn't really clarified to the industry the appropriate response for the majority of the questions," says Justin Nadler, president of hedge fund administrator

HedgeServ. "The recent FAQs issued [in July] have not been very helpful to fund managers who already knew they would have to file."

The problem areas include the cash and financing questions and those concerning prime brokerage, collateral and counterparty risk, which really require that fund advisers know what their prime brokerage documents say and how prime brokers use them. According to Gary Kaminsky, principal in the business advisory services group at Rothstein Kass, some questions ask clients to fit round pegs into square holes. "Question 42 asks for a series of stress tests that many firms don't do in the manner described," he explains. "Questions 40, 41 and 42, concerning risk, are probably the hardest on the form."

What is clear is that the information provided on Form PF needs to be deliberative, accurate and supportable so that it can be audited by the SEC afterwards. Where clients are uncertain about how to answer questions, advisers suggest that they explain their assumptions and the methodology they used to provide their answers. "Anywhere on the form where you are invited to explain your methodology and assumptions, it's critical that you are use that," says Nick Tsafos, an audit partner in the financial services practice at EisnerAmper. "You need to be as transparent as you possibly can."

Consistency is also pretty critical. "It will be hard for the government to use the data on Form PF to understand systemic risk in the near term, but the SEC enforcement division will look at Form PF, along with ADVs and other third-party reporting documents, and try to find disparities," says Kaminsky.



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The challenge for early filers

That means making sure the information obtained from prime brokers, auditors and administrators is uniform, a big challenge for the largest funds that might use four or five different administrators alone. "If you have many different service providers supplying you with information, whoever is aggregating that information for the adviser needs to ensure that the information on Form PF, on tax returns and on ADV is all consistent," says Tsafos. The largest fund advisers have to report for each fund they manage, but also have to aggregate this information at a firm level.

According to Kaminsky, the complexity of the task, and the involvement of a fund adviser's front office and back office, along with all their service providers, makes filing Form PF more of an exercise in enterprise risk management, than a straight regulatory filing. "I like to say that Form PF is the biggest onion I've ever peeled and every day we're discovering

a continual process. As more funds register, more questions will come up for the SEC, and the SEC will be continuously updating their FAQs." As a result, fund advisers are not going to file Form PF until they absolutely have to. In this situation, there is no first-mover advantage.

However, some advisers believe a big burden will fall on those smaller funds that file Form PF later, even if they do have more time. "As daunting a process this is for large private fund advisers, it will be equally, if not more, challenging for smaller private fund advisers, who generally have less personnel in their organizations to support this effort," says Beth Wiener, partner-in-charge of Marcum's alternative investment group.

For funds large and small, the likely costs of compliance with Dodd-Frank as a whole are significant. According to Wiener, that can range from \$25,000 to \$125,000 for small managers, \$125,000 to \$500,000 for medium-size managers and in excess of \$500,000 for larger ones, as fund managers will either need to do all the work in-house, which will require additional staff, or outsource it.

"Fund managers will most likely rely on their service providers—such as administrators and prime brokers—for information, which will increase those fees," Wiener says. "Hefty technology costs will also be incurred in order to aggregate the data, map it, report it and store it for future use. All of these resources, as well as for industry consultants, will no doubt place a heavy financial burden on fund managers."

There are few signs that fund advisers are changing their strategy to



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new aspects to it. I speak to the SEC almost daily to get their guidance."

Some of the first filers are struggling to meet their deadline, whereas the subsequent filers will at least have the experience of the first filers to draw on and, in all likelihood, more SEC guidance by the fall. As William Pidgeon, audit partner in J.H Cohn's financial services industry practice, puts it, "This will be

avoid compliance altogether. "People, for the most part, are staying true to their strategy, whether it creates more regulatory reporting or not, particularly if it is generating good returns. After all, this is what they've sold to investors," says Jay Levy, J.H. Cohn's partner and the financial services industry co-practice director. "A change in style would almost mean that they would have to go out and start a new fund."

Still, Wiener thinks that more funds may well stop accepting external investment if they are subject to much more regulation. "Should additional regulation come into play, I imagine that we will see more managers exiting the traditional fund structure by returning money to their outside investors and

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continuing to trade for themselves. We have seen this occur over the past few years as this current regulation has taken shape."

FATCA implementation on the horizon

If Dodd-Frank wasn't enough to worry about, implementation of the Foreign Account Tax Compliance Act (FATCA) will begin in January, almost three years

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after it was signed into law. "If you talk to U.S. managers, Form PF and FATCA are the two things that they are most worried about from a regulatory perspective," says Nadler.

FATCA is an effort by the Internal Revenue Service and the Department of Treasury to gain transparency over where U.S. residents have assets. It will force foreign financial institutions (FFIs), including all funds registered in the Cayman Islands, to register with the IRS and enter into an FFI agreement by June 30 2013. They then have a year to provide information about their U.S. investors and, will have to certify compliance with the FFI agreement on an annual basis.

If they don't, they will be subject to a 30 percent withholding tax on everything from U.S.-sourced interest income and dividends to the gross proceeds on the sale of U.S. securities, which is compelling. "They would go out of business pretty quickly if they didn't

CFOs at alternative investment funds. "About 70 percent of participants who responded to polling questions said they knew about FATCA, but don't have a plan yet," says Mike Laveman, tax partner in the financial services group at EisnerAmper. "We're telling clients that they need an action plan right now for how they're going to attack this."

The biggest task for hedge funds, domestic or foreign, will be investigating who their investors are. "Funds will have to look up the chain of ownership and figure out who the end investors are, which is particularly difficult for funds of funds, and to put processes in place to ensure that they really know who their new investors are," explains Wall. He says fund advisers are already developing internal checklists on how to do this. "They are also talking to upstream and downstream distributors, custodians and clearing houses so those parties do not withhold tax from them."

To make matters more complicated, the final regulations expected to be published in September could be significantly different from the draft regulations issued in February 2013. A draft intergovernmental agreement announced in July that would allow hedge funds in France, Germany, Italy, Spain and the U.K. to provide FATCA information in their own countries could potentially circumvent the need for funds from these countries to register with the IRS at all. However, it is unclear whether this agreement will



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comply," says James Wall, principal at J.H.Cohn. US funds have to comply with FATCA by January 1 and investigate who their investors are. They also must determine whether their foreign investors are participating FFIs or not.

With deadlines fast approaching, fund advisers need to act now. EisnerAmper had a webinar on this subject in July with about 350 fund managers and

be finalized before funds have to register otherwise.

The drive towards further regulation

Overall, there isn't any indication that the regulatory pressures on hedge fund advisers will abate. While some believe that some regulations could be scaled back or scrapped altogether if the Republicans win the presidency and gain ground in Congress after the November elections, the current trend in the U.S., and indeed globally, is to increase the scope of regulation.

There may have been too many recent lapses for the regulatory drive to stop. "You need to look no further than the slew of headlines that have come out recently, from Knight Trading to JP Morgan to MF Global, to understand the importance of enterprise



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risk management," says Kaminsky. "Given the current climate, it doesn't appear there will be a slowdown of new regulations anytime soon."

Wiener worries that this could put small funds out of business altogether. "At some point, the cost of regulatory compliance will exceed their revenue streams, forcing them to close. It's an unfortunate progression that the industry seems to be following." ■

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