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Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Rule-comments@sec.gov
Reference: File Number S7-22-22

Re: Form PF; Reporting Requirements for All Filers and Large Hedge Fund Advisers (File Number S7-22-22)

Dear Secretary Countryman:

CFA Institute respectfully submits this comment letter to the Securities and Exchange Commission ("SEC" or "Commission") and the Commodity Futures Trading Commission ("CFTC") in response to its published notice of proposed amendments to Form PF (the "Proposed Rules" or "Proposing Release").

CFA Institute[1] is a global, not-for-profit professional association with more than 80,000 U.S.- based members who function as chief investment officers, investment advisers, and portfolio managers on the buy side of the market; as brokers, investment bankers, and financial analysts on the sell side; and as consultants, chief financial officers, regulators, and academics elsewhere in the financial markets. Our membership is bound by a common commitment to the CFA Institute Code of Ethics and Standards of Professional Conduct ("Code and Standards") that require all members and candidates to "place their clients' interests before their employer's or their own interests."[2] CFA Institute speaks on behalf of its members and advocates for investor protection and market integrity before standard setters, regulatory authorities, and legislative bodies worldwide.

Executive Summary

Our comment letter focuses primarily on the performance-related components of the proposal. We support the expansion of the Form PF performance section, to allow internal rates of return and to include additional risk metrics. Due to the length of the Proposed Rules, and the short comment period, our letter does not respond to all questions that were posed in the Proposing Release. Our decision to not respond to any specific question should not be viewed as an indication of support or opposition to such matters.

[1] CFA Institute membership globally includes more than 190,000 CFA® charterholders from more than 160 markets.

[2] CFA Institute Code of Ethics and Standards of Professional Conduct: https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/code-of-ethics-standards-professional-conduct.pdf

Detailed Comments

Definition of Hedge Fund

We agree with the Proposing Release's comments that many private equity funds may inappropriately fall into the current definition of hedge fund for purposes of Form PF. We believe that including a requirement for the "reporting fund to provide redemption rights in the ordinary course," as proposed within question 99 of the Proposing Release, would be an appropriate way to eliminate private equity funds from being deemed a "hedge fund" for purposes of Form PF.

Reporting Fund Aggregate Calculated Value

We agree with using reporting fund aggregate calculated values for a rate of return calculation. As defined in Form PF, the gross asset value and net asset value (which align with Form ADV) are not appropriate for performance calculations. Because the accuracy of performance returns is highly dependent on the validity of fund valuations, we have several comments on the proposed definition of reporting fund aggregate calculated value.

First, any private fund that allows for investor subscriptions and redemptions is required to value the fund, at a minimum, at the time of any subscription or redemption. To determine this valuation, investments need to be fairly valued, earned income needs to be recognized, and expenses need to be accrued. If such valuations are available, we recommend requiring using such valuations.

Second, the proposed definition states that it is not necessary to adjust the reporting fund aggregate calculated value for accrued fees or expenses. Form PF proposed question 23(a) requires the fund's gross and net monthly performance. To calculate a fund's net performance, fund valuations must reflect the deduction of fees and expenses incurred by the fund.

Finally, the reporting fund aggregate calculated value is used within the definition of rate of return, which is defined, in part, as "the percentage change in the reporting fund's aggregate calculated value from one date to another and adjusted for subscriptions and redemptions." This definition would apply only to those funds that calculate time-weighted returns, and not an internal rate of return (IRR). The internal rate of return definition does not address the valuation used for the terminal value in the IRR calculations and refers back to the rate of return definition. It is unclear, however, how the language within the rate or return definition applies to an internal rate of return. For example, the Adopting Release could explain that the reporting fund aggregate calculated value should be used as the terminal value in the IRR calculation, with one exception. Depending on what the rule requires in terms of reporting a return with or without the impact of subscription facilities, this type of leverage should be treated differently than other types of leverage in the private fund. For example, if a return is being calculated without the impact of a subscription facility, and the subscription facility is still open, the terminal value needs to be grossed by the amount that is due to the subscription facility.

Use of Subscription Facilities

The Proposing Release is silent on how the use of subscription facilities affects IRR calculations. In our comment letter on the Private Fund Advisers proposal (File No. S7-03-22), we recommended requiring IRRs both with and without the impact of subscription facilities, because doing so would allow investors to understand the impact of the adviser's decision to use a subscription facility. We recognize, however, that the returns in Form PF are used for other purposes. We recommend specifying which returns should be used (with or without the impact of the subscription facilities) and when Form PF reporting should begin; the starting date of the IRR will depend on whether returns are reported with or without the impact of the subscription facility.

Returns

Definition of Internal Rate of Return

We agree with the definition of internal rate of return. However, we recommend clarifying how the concepts discussed within the rate of return definition, including reporting fund aggregate calculated value and currency, are reflected in the internal rate of return calculation.

Definition of Rate of Return

We have two comments on the rate of return definition:

- New Question 23(a) requires a fund to provide gross and net performance in USD, unless such information is reported to current and prospective investors, counterparties, or otherwise, in a currency other than U.S. dollars, in which case the adviser should report the data using that currency, and identify the currency in Question 4. The definition of rate of return states that returns reflect the change in value in the reporting fund's base currency. This language contradicts the language in Form PF. We recommend clarifying whether returns should be calculated using a fund's base currency or the currency used to report performance to current and prospective investors, counterparties, or otherwise.
- The definition states, "For a portfolio position, the rate of return is the percentage change in the position calculated value, adjusted for income earned." The Proposed Rules do not require a rate of return for individual portfolio positions. We therefore recommend removing this part of the definition. If the language about a portfolio position is included in the final rule, we recommend modifying it because a position return cannot be calculated by considering only the change in a portfolio position's value adjusted for income. The calculation must also consider changes in the quantity held of the portfolio position resulting from transactions, such as purchases, sales, and corporate actions. We recommend editing this language to state: For a portfolio position, the rate of return is the percentage change in the position calculated value, adjusted for income earned <u>and changes in the quantity held of the portfolio position</u>.

Differentiating Between Internal Rate of Return and Periodic Rate of Return

The Proposing Release includes an exception to the tabular reporting for those funds whose performance is reported to current and prospective investors, counterparties, or otherwise as an IRR since inception. An IRR is appropriate when a fund has the ability to call capital and distribute capital. We recommend strengthening the language as to when it is appropriate to use an IRR by including this concept. We also recommend requiring funds to consistently report the same type of returns over time (i.e., not switch between a rate of return and an IRR), which would improve the usefulness of Form PF data.

The Proposing Release includes the following explanation as a distinguishing factor between an IRR and a periodic rate of return calculation: "These calculations may differ in the way they reflect realized and unrealized gains, among other things." We recommend modifying this explanation. Both time-weighted returns and internal rates of return reflect realized and unrealized gains during the respective period. Both types of returns may also be calculated for positions that have been sold, or realized, but this concept has no impact on return calculations for a fund.

References to Performance

Form PF includes many references to "performance" but "performance" is not defined. In most cases, it appears that the intention is to describe a fund's return. In those cases, we recommend using the term "return" or explain that "performance" means return, if that is the case.

There are other times where the term performance is used to describe a time-weighted return or an IRR, but not both. In those cases, we recommend replacing the term performance with rate of return or IRR. For example, in new Question 23(a), the form states that the adviser should "provide the reporting fund's gross and net performance." This section is intended for funds that report time-weighted returns. Assuming that the intention is for the term "rate of return" to apply only to funds that report time-weighted returns, then we recommend instead this alternative; "provide the reporting fund's gross and net rates of return." If this change is made, then the header of the table in Item C that says "Gross performance" should instead say "Gross rate of return." The column that is labeled "Net of management fees, incentive fees, and allocations" should instead say "Net rate of return." There is similar language in new Question 23(b) where performance is used instead of IRR.

Gross and Net

While the terms "rate of return" and "internal rate of return" are defined, the terms gross and net in relation to these terms are not. Within the table in section 23(a), the headings are "Gross performance" and "Net of management fees, incentive fees, and allocations." These headings imply that the difference between gross and net returns would reflect the impact of only management fees, incentive fees, and allocations.

Also, the Proposed Rules do not specify whether either of these returns must reflect the deduction of other fund fees and expenses. If the Proposing Release intends for net returns to reflect the deduction of *all* fund fees and expenses, we recommend explicitly stating this fact. If net returns reflect the deduction of *all* fees and expenses, as the heading in the table for net performance implies, this would mean that gross returns reflect the deduction of all other fund fees and expenses.

This approach to gross performance would not be consistent with the SEC Marketing Rule, which does not require the deduction of *any* fees or expenses, including transaction costs. It would also not be consistent with the Private Fund Advisers proposal, which would require gross returns to not reflect the deduction of any fees or expenses. We note that this approach is consistent with returns that are provided in fund financial statements, where gross returns are net returns that are grossed up by only management fees, performance fees, and carried interest. The Global Investment Performance Standards (GIPS®) take yet another approach, and require that gross returns reflect the deduction of only transactions costs; other fees and expenses may be deducted, but this is optional. Given the variety of gross returns that are used in the industry, we recommend defining gross returns, and clarifying which fees and expenses, if any, should be deducted when gross returns are calculated.

Risk

Condition for calculating a market value on a daily basis for any position

New Question 23(c) states that an adviser would need to provide the reporting fund's aggregate calculated value and risk metrics if it calculates a market value on a daily basis for any position in the reporting fund's portfolio. We struggle to understand this approach. For example, if a fund can calculate its daily cash position or a daily market value for one security, but it cannot calculate a market value for the remainder of its holdings on a daily basis, it would not be able to calculate the reporting fund's aggregate calculated value and risk metrics on a daily basis. A fund would need to have current valuations for all of its securities on a daily basis in order to calculate an accurate reporting fund aggregate calculated value and corresponding risk statistics using daily information. We recommend instead requiring an adviser to provide the reporting fund's aggregate calculated value and risk metrics using daily information only when it calculates a market value on a daily basis for the reporting fund's portfolio.

We suggest that the Adopting Release should add a risk section based on monthly or quarterly fund returns. There are many private funds that use time-weighted returns and value their portfolios and calculate performance on a monthly or quarterly basis. Requiring these funds to report standard deviation and drawdown measures will expand the population of funds being monitored.

We also suggest clarifying whether standard deviation and drawdown measures should be calculated using gross or net fund returns.

Use of natural log

New Question 23(c)(ii) requires filers to provide the reporting fund's volatility of the natural log of the daily rate of return for each month. Typically, log returns are used when returns are assumed to be lognormally distributed. Taking the natural log of a lognormal distribution would change it to a normal distribution, therefore enabling the use of risk statistics that assume a normal distribution, such as the standard deviation.

When simulating returns, such as when doing a mean-variance optimization, users can specify a lognormal distribution because they essentially have an infinite number of (hypothetical) returns to choose from. A user would prefer to use a lognormal distribution, because the lowest return possible is 100%, and an unleveraged investment cannot lose more than 100%. In cases such as this, it is appropriate to use the natural log of returns because it will create a normal distribution from the lognormal distribution. However, the distribution of actual historical private fund returns is predetermined based on what actually happened, and it is likely that these returns are not lognormally distributed.

If actual historical private fund returns are not lognormally distributed, then we believe it is not appropriate to require a standard deviation using the natural log of the returns. We believe Form PF should use simple returns for comparability with other fund information, including returns, which are not calculated using log returns.

Small population size

The calculation requires the natural log of the daily returns within a month. This will lead to a population size that ranges from 19-22 days. Because a larger population of daily returns in the calculation would provide more meaningful information, we recommend measuring volatility over longer periods, such as a quarter or year.

Annualized standard deviation

New question 23(c)(ii) states that the standard deviation of the daily rates of returns should be multiplied by the square root of 252. By multiplying the daily standard deviation for a month by the square root of 252, the risk number will be simulated because it is projecting what may occur over a year based on what happened in that month. This may or may not be the case. Therefore, we recommend noting that this is a hypothetical risk number.

The label in the proposed Form PF describes this figure as the “Monthly volatility of returns.” Because this volatility measure is annualized, a more accurate description of this information would be “Annualized volatility of daily returns.”

Standard deviation formula not specified

The Proposed Form PF states that the reporting fund’s volatility would be “computed as the standard deviation of the natural log of one plus each of the daily rates of return in the month.” There are two common formulas used for standard deviation. The first is the standard deviation of the population, which uses “n” (the number of observations) in the denominator. The second is the standard deviation of the sample, which uses “n-1” in the denominator. For clarity, we recommend specifying which formula should be used. When calculating standard deviation that is required by the GIPS standards, we allow either formula, but state that the use of n is best practice and preferable when the data set is known and it is not a sample.

Peak to trough drawdown

New Question 23(c)(iv)(A) requires information about the fund’s most recent peak to trough drawdown. For clarity, we recommend changing “Amount in base currency” to “% in base currency.” Also, in our comment on the definition of “rate of return,” we noted an inconsistency within Form PF about which currency must be used to calculate returns. If the final rule requires returns to be based on the currency used to report information to current and prospective investors, counterparties, or otherwise, as opposed to base currency, then this section of Form PF should also be modified to align with the return and other risk information.

We believe that it would be very helpful to provide definitions for, and examples of, how to calculate the most recent and largest peak to trough drawdown within the Rule Text and Adopting Release. We recommend using the following definitions:

> Maximum peak to trough drawdown: the maximum observed loss from a peak to a trough using the fund returns for the reporting period. The maximum peak to trough drawdown is calculated as (trough value – peak value) / peak value.
>
> Most recent peak to trough drawdown: the most recent observed loss from a peak to a trough using the fund returns for the reporting period. The most recent peak to trough drawdown is calculated as (trough value – peak value) / peak value.

Conclusion

Thank you for your consideration of our views and perspectives. For questions about this comment letter, please contact [redacted] or [redacted]

Sincerely,

Paul P. Andrews
Managing Director
Research, Advocacy, and Standards
CFA Institute

cc:
Commissioner Gary Gensler
Commissioner Hester Peirce
Commissioner Caroline Crenshaw
Commissioner Mark Uyeda
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