

When AI Failures Could Be “Operations Events” Under Form PF

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Asset managers are increasingly incorporating AI into critical operations, such as investment, trading, valuation, reporting, and risk management, either through vendor solutions or in their own processes. As with any dependency, asset managers must assess and prepare for potential failures that could result in the need for business and operational responses, as well as potential regulatory notification obligations.

Form PF Reporting Requirements. In 2023, the SEC created Section 5 of Form PF on which large hedge fund advisers (defined as registered investment advisers with at least \$1.5 billion in regulatory assets under management (RAUM) attributable to hedge funds as of the end of any month in the prior fiscal quarter) to qualifying hedge funds—that is, hedge funds with a net asset value of at least \$500 million—must report on certain current significant events, including “operations events.” An “operations event” is a “significant disruption or degradation of the reporting fund’s critical operations, whether as a result of an event at a service provider to the reporting fund, the reporting fund, or the adviser.”

“Critical operations” include operations necessary for either the investment, trading, valuation, reporting, and risk management of the reporting fund or the operation of the reporting fund in accordance with federal securities laws and regulations. While the SEC initially proposed to define a “significant” disruption as a 20% disruption or degradation of normal volume or capacity, the final version of Form PF did not adopt that definition. Nevertheless, the SEC in the Adopting Release observed that a “20 percent disruption or degradation of normal volume or capacity generally might be indicative of the types of stress for which reporting may be necessary.”

In the case of an operations event, large hedge fund advisers must report the event to the SEC as soon as reasonably practicable, but no later than 72 hours upon the occurrence of the event. Because the \$1.5 billion in hedge fund RAUM trigger for becoming a “large hedge fund adviser” is retrospective,¹ a registered adviser that does

¹ See the **Form PF Instructions** for additional detail on how to calculate assets under management (AUM) for purposes of determining whether an adviser meets the threshold for classification as a large hedge fund adviser, including guidance on the treatment of related persons and aggregation requirements.

not currently meet that AUM threshold should closely monitor its month-end AUM attributable to hedge funds to ensure compliance with critical operations reporting obligations for any “qualifying hedge fund.”

When Could an AI Failure Trigger Reporting? It is clear that “operations events” can result from disruptions such as a cybersecurity attack or a power failure. But with firms increasingly reliant on AI for critical functions, there is also a significant risk that the unavailability of an AI model that is a key element of, for example, a trading platform or a core compliance system could trigger reporting on Form PF, even if the event occurs entirely at an AI service provider.

Take one illustrative example: A hedge fund adviser relies on a cloud-hosted large-language-model application that auto-codes client-specific investment restrictions into its order management system. A regional cloud outage knocks the model offline for three hours, during which roughly 25 percent of trades are rejected or delayed. Trading capacity drops below the firm’s 80 percent internal threshold, forcing the desk to halt activity and invoke its incident response plan. Because the disruption affects a critical trading function and exceeds the 20 percent degradation benchmark, it may be a reportable “operations event” under Form PF.

Practical Considerations for Asset Managers. As AI solutions are increasingly adopted, both in-house and at vendors, asset managers should consider the potential operational impacts of a failure of such technology, either because the performance of a critical AI model becomes so unreliable as to render the model unusable, or because the model itself is not available. Such an evaluation is particularly important given the heightened regulatory attention and scrutiny facing AI usage.

Accordingly, asset managers that are adopting AI for core functions should consider:

- **Establishing Clear Reporting Thresholds and Escalation Pathways:** Consider assessing whether failures of adopted AI technologies could result in significant disruption or degradation to critical operations; if so, establish triggers and processes for escalating certain events to facilitate timely analysis of potential Form PF reporting obligations.
- **Reviewing and Updating Business Continuity and/or Incident Response Plans:** Consider updating business continuity and/or incident response plans to address the risks of critical AI disruptions, alongside cybersecurity and other types of business continuity risks.
- **Enhancing Vendor Due Diligence:** Consider whether processes for vendor due diligence should include an assessment of AI solutions used by any critical vendor,

including ensuring contractual obligations on the vendor under which it must provide timely notification (e.g., no more than 24 hours) of an AI-related event that could trigger a Form PF reporting obligation for the firm.

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