COMMENTS RECEIVED ON THE CONSULTATION REPORT

Principles For The Valuation Of Hedge Fund Portfolios

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

JULY 2007

Contents:

Alternative Investment Management Association
The Forum for Hedge Funds, Managed Futures and Managed Currencies

Ms. Pamela Vulpes,
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28006 Madrid.
Spain

Also by email to: pamela@iosco.org

21st June 2007

Dear Ms. Vulpes,

" Principles for the Valuation of Hedge Fund Portfolios" -
AIMA's public comment on IOSCO Consultation Report (March 2007)

The Alternative Investment Management Association Limited ("AIMA") is – some 17 years after its establishment - the only professional trade association representing the hedge fund industry with worldwide membership. It is also the only such association which represents all practitioners in the alternative investment management industry – whether hedge fund managers, funds of funds managers, managers of futures or currency funds or those providing other specific services such as prime brokerage, administration, legal or accounting, auditing and tax advisory services.

AIMA is a not-for-profit trade association whose role is to represent the global hedge fund and related industry to policy makers, regulators and other supervisors, institutional investors, the media and the rest of the financial industry through policy development, regulatory interaction, the development and distribution of educational and research materials and to advance sound practices. Its membership is corporate and now comprises over 1,170 firms in 47 different countries. AIMA's growth has been commensurate with the development of the hedge fund industry worldwide.

The three 'pillars' of AIMA are:

- Education;
- Regulation; and
- Sound practices.

AIMA's objectives specifically include providing an interactive and professional forum for our membership and acting as a catalyst and promoter of the industry's global development. We aim to provide leadership to the industry and to be its pre-eminent voice; we also strive to develop sound

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practices, enhance industry transparency and education and liaise with the wider financial community, institutional investors, the media, regulators, governments and other policy makers.

Overview

We are grateful for the opportunity to respond to the Consultation Report on **Principles for the Valuation of Hedge Fund Portfolios** (the Report) issued by IOSCO's Technical Committee Standing Committee on Investment Management (SC5) in March 2007, following a mandate given to the Technical Committee in February 2006 .

Although problems concerning the pricing and valuation of portfolios are by no means unique to the hedge fund industry, AIMA and its members recognised the need to establish clear recommendations on this topic in 2003. AIMA undertook global research into the perceived and actual difficulties found in the pricing and valuation of hedge fund portfolios and issued original findings and recommendations in May 2005. In early 2006, AIMA felt that it would be appropriate to analyse more deeply the various areas in the valuation process and issued its Guide to Sound Practices for Hedge Fund Valuation ('GSP') in March of this year, at the same time that the IOSCO Report was published. A copy of the GSP is attached to this letter.

AIMA's GSP includes 15 recommendations for the industry and for investors and has been shared with regulators, fiscal and governmental authorities; the GSP has also been sent to all component parts of the industry (including those who are not members of AIMA but have requested a copy) and to all of AIMA's 700 institutional investor contacts. The GSP reflects more detailed representations from stakeholders and takes full account of ongoing developments in the industry, such as the increasing use of side pockets. The Recommendations are intended as principles-based guidelines for valuation sound practices in the areas of governance, transparency, procedures and methodology.

Very briefly, AIMA's GSP advocates that:

- under the usual terms of its constitution, a Fund's Governing Body has ultimate legal responsibility for the valuation of the Fund's portfolio;
- in practice, the Governing Body will delegate responsibility for the production of the Fund's Net Asset Value to another party - the Valuation Service Provider, who will, typically, be the Fund's Administrator (but it might be a division of the Fund's Investment Manager);
- the tripartite relationship of Governing Body, Valuation Service Provider and Investment Manager will vary between Funds but it is central to the management of independence and competence, which is at the heart of the valuation process;
- every Fund should have in place a detailed Valuation Policy Document, approved by the Governing Body after consultation with other stakeholders;
- conflicts of interest are often best managed by the appointment of an independent and competent Valuation Service Provider;
- If the Investment Manager is responsible for valuation and/or governance, adequate controls over conflicts of interest should be put in place.

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AIMA's comments on the Principles proposed in the Report

The Report sets forth principles intended to apply consistent valuation policies and procedures for hedge fund portfolios and to ensure independence and transparency in such valuation process. IOSCO's proposed principles are close to AIMA's own Recommendations and many of the industry practitioners who worked with IOSCO's SC5 to produce the Report are members of AIMA and also worked on our GSP. We have been pleased by the consideration given to the subject of valuation in the Report, the great efforts taken to engage with industry in its development and the principles contained there. We also believe that the Report and the GSP demonstrate that the industry and the regulatory community have worked closely together on this important subject. We would emphasise that the Report and the GSP are by no means contradictory and demonstrate that all interested parties are "thinking in the right direction".

The complexities of some hedge fund strategies and instruments now in use and the desirability of managing potential conflicts of interest in the valuation process are very important areas for consideration and recommendations.

It should be noted that neither AIMA nor IOSCO has addressed issues relating to the Gross Asset Valuation of each Fund. AIMA felt it to be outside its remit to comment on or issue Recommendations regarding the speed and frequency for each Fund's Net Asset Value to be issued. Such Recommendations could not be applied to every Fund, given the wide nature of the instruments traded.

AIMA's responses to the questions posed in the Report

Q1 What is your opinion of each of the principles?

AIMA is in an unusual position in that it is able to 'map' the IOSCO principles to AIMA's own Recommendations on Valuation released this year.

We can state that every one of IOSCO's Principles is addressed in our GSP, with the exception of Principle 9. Throughout AIMA's section on Transparency (Recommendations 4-7 inclusive), we refer to the need to make available all salient information to the investor; therefore, Principle 9 is implied, although not separate stated*.

For assistance, we show here the IOSCO Principle numbers and their corresponding AIMA Recommendation:

IOSCO	AIMA
1	1
2	1

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3	11
4	1
5	3
6	3,6, 7, 9
7	1, 12
8	1
9	- *

Q2 Has IOSCO correctly identified the challenges inherent in the valuation of hedge fund financial instruments?

Each of IOSCO's Principles is accurate and fairly reflects the current situation. However, arguably the largest, ongoing challenge facing those pricing instruments traded by hedge funds is the continuous development of new instruments, particularly those that may not be exchange-traded.

There is a wide range of types of assets in which funds can invest, which vary from easy- to hard-to-value. Different pricing specialists, managers and/or investors may select different pricing methodologies for instruments. One size does not fit all and, accordingly, AIMA cannot state which pricing models are the most appropriate and neither, we believe, could IOSCO.

Q3 Has IOSCO correctly addressed those challenges?

It would not be appropriate nor easy for IOSCO to address the challenge of pricing new instruments.

Q4 In what ways could the principles be amended to further benefit investors in hedge funds?

At this stage in time, at least, we believe the Principles to be fair and appropriate.

Q5 Are there material obstacles to the implementation of the principles within hedge funds?

The only obstacle identified by AIMA may be that of cost for those funds that may not currently adhere fully to the AIMA Recommendations or IOSCO Principles. Any costs incurred by fund managers who seek to abide by the Recommendations/Principles should be relatively minor in the context of the overall value of the Fund; however, institutional investors now form the majority of hedge fund investors and they require robust procedures to be in place.

Q6 Are there additional principles that would benefit hedge fund investors?

AIMA's Recommendations 2, 4, 5, 8, 10, 13, 14 and 15 offer additional and more detailed Recommendations on topics relating to governance, transparency, processes and methodology. We would suggest that IOSCO refer to these and to the GSP in its final report.

Q7 What, if any, additional specific measures should be incorporated within the policies or

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procedures to enhance the principles? Please see our response to Q6 above.

As one final point, we would add that our view is that, given the nature of the subject and the significant progress already made by the industry, and when "no one size fits all", regulation would neither be appropriate nor helpful.

We trust that these comments will assist the consultation and we are most grateful to IOSCO and SC5 for their stated intention to engage with the industry closely in the discussion process. We will be happy to discuss any part of our comments further, if that would be helpful.

Yours sincerely,

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19 June 2007

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Dear Ms Vulpes

RESPONSE TO THE IOSCO CONSULTATION ON PRINCIPLES FOR THE VALUATION OF HEDGE FUND PORTFOLIOS

Thank you for the opportunity to respond to your Consultation Paper on the risks and regulatory environment relating to hedge fund portfolios.

The BBA is the leading UK banking and financial services trade association and acts on behalf of its members on domestic and international issues. Our 219 members are from 60 different countries and collectively provide the full range of banking and financial services. They operate some 130 million personal accounts, contribute £35bn to the economy, and together make up the world's largest international banking centre.

We have been active in the field of hedge fund regulation in the UK context, and responded to the UK Financial Services Authority's Discussion Paper 05/4, "Hedge funds – a discussion of risk and regulatory engagement". A copy of the BBA's response to this DP is attached as appendix I.

We would support IOSCO's analysis of the increasing importance of hedge funds to global capital markets. We also see it as appropriate for IOSCO to develop a series of high-level principles in the area of hedge fund valuation, in order to ensure consistency and appropriateness in this field, and that values are not distorted to the disadvantage of fund investors.

This is especially appropriate work for IOSCO, rather than our national regulator, to carry out given the cross-border nature of much hedge fund activity.

We support the nine principles for hedge funds. In particular we agree that the information set out in paragraph 9 of the nine principles is information that should be made available to investors upon request.

However, we do not believe that IOSCO should mandate the format of such procedures. Hedge funds operate with a wide variety of business models, and a “one size fits all” approach is unlikely to be appropriate. Indeed, given the complex and dynamic nature of the hedge fund industry, such an approach would be likely to constrict the dynamism that has made the industry such a success.

This would be of benefit neither to the practitioners in question, nor to investors.

If you would like to discuss any of the issues raised in further detail, please contact Michael McKee on + 44 020 7216 8858, michael.mckee@bba.org.uk or John Ewan on +44 020 7216 8856, john.ewan@bba.org.uk

Yours sincerely

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28th October 2005

Dear Mr Shrimpton

RESPONSE TO DP05/4 – HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT

Thank you for the opportunity to respond to your Discussion Paper on the risk and regulatory engagement with hedge funds.

We are in full agreement with the FSA that hedge funds are growing in importance in the market, and are increasingly significant in the provision of market liquidity. In addition, the investor base of hedge funds appears to be widening to include greater retail involvement (although currently the criteria for investment – e.g. the amount that must be invested – are actually making it more difficult for retail investors to take a direct investment in a hedge fund).

We agree with the FSA that it would not be beneficial if regulatory action caused this increasingly important industry sector to move to more lightly regulated jurisdictions. We are also supportive of your proposal to carry out a full cost-benefit analysis of any additional regulation.

Regulatory remit

A key issue in relation to the regulatory environment in which hedge funds operate is the remit of any individual regulator to exercise "regulatory grip" over their activities. Our principal suggestion is that the most appropriate way of ensuring that hedge funds, with their almost intrinsically cross-border nature, are best regulated is through multilateral initiatives rather than purely national means. IOSCO and AIMA, for example, appear to be appropriate organisations to develop industry-based codes of good practice in this area.

Any work done by the FSA should clearly be co-ordinated fully with initiatives at EU level and beyond, such as the suggestion in the recent European Commission Green Paper on asset management to set up a working group on hedge funds.

Monitoring hedge fund activity

We believe that the FSA already possesses many tools which will allow it to monitor hedge fund activity, and that the focus of FSA work should mainly be on gathering information and assessing risks. This is especially pertinent given the offshore base of most hedge funds, making it potentially problematic for the FSA to impose a sufficient level of regulatory grip to provide the degree of investor protection they desire.

Another issue lies around demarcation: the FSA has the authority to authorise hedge fund managers but not hedge funds themselves. This limits the regulation that the FSA is legally able to carry out. It is also worth noting that hedge fund managers are already regulated, the firms that run the funds are regulated, and the cash flows in and out of the vehicles in question are also regulated. This already provides a reasonable level of investor protection.

This existing level of regulation means, in our view, that the FSA should broadly be wary of imposing potentially duplicative regulatory burdens on the industry, such as making hedge fund management a notifiable event under the Handbook, or differentiating prime brokers from other types of regulated entity.

Finally, we would suggest that the FSA needs to be careful to avoid a perception that it has more regulatory control over hedge funds than it has in reality. There could be a risk of "moral hazard" if there were too big a gap between perception and the actual degree of regulatory control which the FSA has. This risk would appear to be most significant in relation to the proposals relating to non-mandatory requests for provision of information. How vulnerable, for example, would the FSA be if a hedge fund had voluntarily provided some financial information to it, but was not otherwise supervised by the FSA?

Development of good practice guidance

We are supportive of the FSA playing a facilitating role in relation to hedge funds, helping to develop good practice in this industry sector, rather than imposing additional regulation. As you point out in the DP, there is a need for a global approach in relation to hedge funds, in order to avoid regulatory arbitrage. Your proposed conference is an excellent opportunity to move this forward. One particular area of focus should be increased transparency and timeliness of fund valuation and investment strategy.

In addition, we feel that good practice guidelines in relation to stress testing would be helpful to the industry and to investors, especially given the plethora of different models currently in use.

As we note above, given the necessity of a global approach, we recommend that the FSA works with IOSCO and other cross-border institutions such as AIMA, in order to develop a code of good practice for hedge fund regulation. This code should be supported fully by industry – whether hedge fund managers, prime brokers or pertinent institutional investors – in order to ensure that it facilitates rather than discourages further developments in these increasingly significant products.

The appendix to this letter provides our detailed answers to the specific questions you pose in the Discussion Paper.

If you would like to discuss these views in further detail, please do not hesitate to contact either me or Philip Buttifant, a Director in the BBA's Wholesale Team.

Yours sincerely

Michael McKee
Executive Director

<u>Appendix – comments on the specific questions within DP05/4</u>

Q1: Are the risks to our statutory objectives outlined in this paper the correct ones?

We agree with the FSA's analysis of the key risks. Valuation risks are an important issue. We agree that weaknesses in asset valuation models have the potential to lead to ill-informed investment decisions and detriment to market confidence. In addition, the plethora of different models used by different funds makes an objective comparison of investment valuation problematical.

An additional risk the FSA may wish to consider is administrative and operational risk, relating to custodial services. Given the nature of hedge funds, especially that most of them are off-shore, back-office functions relating to the holding of client assets are of necessity likely to be more complex, and therefore more prone to error. Thus, we believe that the FSA should also recognise such risks in its overall analysis of the risks surrounding investment in hedge funds. The FSA could regulate administrative and custodial services under its outsourcing requirements where a UK fund manager is appointed custodian and administrator and then subcontracts this function out, but would not have this regulatory remit where the fund appoints the custodian/administrator directly. This potentially leads to an unlevel playing field, and reinforces the need for a global approach to hedge fund regulation.

However, it is uncertain what level of risk mitigation the FSA will be able to impose in practice. Given that most hedge funds are based offshore, it may be problematical for the FSA to impose sufficient regulatory grip to provide the level of investor protection they wish to. Indeed, as the FSA points out, they do not see significant risks to UK retail customers arising in the hedge funds sector. Given that hedge fund investors are overwhelmingly wholesale customers at present, it may be counterproductive to attempt to regulate the sector in a detailed manner, as professional investors clearly require considerably less protection, and more regulation may simply make hedge funds less attractive to those very investors who are currently making them so popular.

Q2: In addition to the FSF and Joint Forum initiatives, are there any global or European regulatory initiatives that could helpfully raise standards in the hedge fund sector?

The BBA has been, and continues to be, an active follower of the work of the Joint Forum, and we support the FSA taking this work into account.

In addition, the recent Green Paper from the European Commission on asset management noted that the Commission intends to establish a working group on hedge funds following feedback received on the Green Paper. It is essential that any UK initiatives are co-ordinated with any related initiatives at EU – or indeed international level. Moves towards independent national regulation of hedge funds may require firms to incur unnecessary costs if they are compelled to bring their processes into line with national regulatory requirements, and will then have to change them again. Consequently, we support an internationally co-ordinated approach, and encourage the FSA to work through IOSCO to develop an international code of good practice for hedge funds.

Q3: Recognising the importance of stress testing as a risk management tool, do you believe that it is sufficiently embedded within the hedge fund sector and should the FSA take any steps to further encourage such practice?

We agree that stress testing is an important risk management tool in the sector, and believe that the conference you propose for the third quarter of 2005 would be very helpful in sharing best practice in this area.

We believe that the FSA should restrict its role in this area to the provision and/or facilitation of good practice guidelines, rather than imposing a regulatory burden. Managers of hedge funds are aware of the benefits of stress testing in managing their risk portfolios, so it is clearly in the interests of themselves and their investors to use these tools.

The BBA and LIBA recently responded jointly to the FSA DP 05/2 on stress testing. Our members found this paper a helpful summary of the FSA's work to date on stress testing, and of its proposed approach. We support the sharing of good practice across the industry, and the development of a principles-based approach to identifying the desirable characteristics that underpin the embedding of stress testing within a firm's overall risk management framework.

It is also worth noting that stress testing relates to hedge fund managers directly, and it should be made clear that such models are not applicable to managers of funds of hedge funds.

Q4: Should the FSA make undertaking hedge fund management a notifiable event under the Handbook or are other alternatives for differentiating such firms preferable, such as requiring them to obtain a specific permission from the FSA before undertaking such activity? Are the investment techniques typically employed by hedge fund managers (such as short selling, using derivatives for investment purposes and the use of economic and instrument leverage), and not issues of legal structure, the optimal characteristics on which to base any definition?

Our view is that hedge fund management should not be a notifiable event. Requiring a specific permission from the FSA would increase the regulatory burden, and the time and resources required to operate a hedge fund, without adding any concomitant investor protection. In addition, it should be noted that the FSA already possesses regulatory authority over hedge fund managers, so additional powers would be redundant.

It is more appropriate for specific investment techniques to be part of any definition of such a notifiable event, as it is potentially high-risk investment techniques that may require investor protection, rather than simply legal structures.

We agree, however, with the FSA's proposal separately to identify hedge funds/hedge fund managers where possible so that they can specifically follow developments relating to hedge funds. The focus should be on the largest and/or the most active hedge funds, as these are the most likely to pose a risk.

Q5: Should we also consider differentiating prime brokers from other types of regulated entity by creating a notifiable event under the Handbook or are other alternatives for differentiating such firms preferable, such as requiring them to obtain a specific permission from the FSA before undertaking such activity?

We do not believe that any further regulation of prime brokers is required, given the FSA's existing powers of regulating firms and individuals. It makes sense, however, for the FSA to follow developments in the prime brokerage area, e.g. through supervisory themes from time to time.

A current example of a supervisory theme relevant here is conflict management, given the risk that hedge fund managers may be favoured above other clients owing to the level of fees they generate for a firm.

Q6: Recognising that, in assessing new regulatory initiatives, the FSA will take into account the regulatory burden imposed on firms and its effect on the competitive position of the UK, what are your views on the optimal scope of enhanced ongoing supervision (focused on market issues) of those hedge fund managers who manage funds with a significant market impact and the methodology for identifying such funds?

We do not have any specific proposals, but agree with the concept of having a marker to differentiate hedge funds from other types of fund, and a separate FSA unit to focus on hedge fund managers. We would suggest that it is important to have a clear dividing line between elements of hedge fund organisation which are within the scope of FSA regulation and those which are outside, and to have very clear boundaries describing these to FSA staff and for external use. If this is not done, the risk of "moral hazard" (see cover letter) increases.

Q7: Recognising that the FSA would take into account the costs and benefits of additional data collection, do you have any suggestions about the optimal data set to be collected from hedge fund managers and could you indicate the likely costs involved in its production?

Our view is that the conference that the FSA proposes would be an ideal opportunity for you to ascertain industry views on the data that you need to collect in order to carry out an appropriate level of hedge fund regulation.

We believe that it is sensible for the FSA to collect some data regarding hedge funds, albeit the amount of data requested from market participants should be proportionate to the risks in question. For example, BBA members who have prime brokerage businesses would be concerned if significantly increased reporting requirements were imposed upon them.

Q8: Should the FSA encourage industry initiatives to improve investor due diligence and best practice as it relates to disclosure? Are there any alternative regulatory actions that should be pursued in this area, for example would you consider it helpful to receive FSA guidance in relation to disclosure, particularly in relation to side letters and managed accounts?

Hedge funds are overwhelmingly invested in by the wholesale market. Therefore, whilst the FSA is well placed to facilitate the production and publication of best practice guidelines, we do not feel it is appropriate for further regulatory action to be pursued in relation to hedge funds. Any guidelines would be best developed internationally, through IOSCO, but it is essential that there is good dialogue with the industry and an open consultation process.

Q9: Do you believe that regulatory action is required with respect to hedge fund valuation? If so, should this aim to stimulate voluntary industry improvements or be more rules based? Should the FSA seek to encourage improvements purely in a domestic context or would international initiatives be more effective? Are there any specific forms of regulatory action that you would recommend?

We do not see regulatory action as beneficial in this context, and would prefer to see regulatory bodies join together with market participants to develop a code of conduct of best practice in relation to hedge fund management and marketing (see our response to Question 8). Similarly, we would prefer that improvement of valuation measures was approached through seeking to stimulate industry improvements. In particular, it should be borne in mind that valuation issues often arise from the unique nature of the complexity of particular instruments – rather than problems with valuation methodology per se. As with our answer to Question 3 above, it should be noted that such valuation methodologies should not apply to funds of hedge funds.

Cross-border rather than unilateral action is appropriate in regard to this issue, perhaps through the medium of AIMA.

Q10: Should the FSA and/or international regulatory bodies encourage the development of a hedge fund code of conduct? What would be the optimal method for facilitating such a development? Are there any particular risks in relation to which such a code could obviate the need for regulatory action?

A hedge fund code of conduct is, in our view, an eminently sensible thing for the FSA to help create. This would ideally be created through a cross-border process, involving the work done to date by the Joint Forum and IOSCO, and work with hedge funds and the financial services industry.

Particular risks that should be noted – other than those already identified by the FSA – are those related to settlement and custodianship, together with more general risks of fraud, especially given the offshore nature of the majority of the products in question.

CFA INSTITUTE | Centre for Financial Market Integrity

21 June 2007

Ms. Pamela Vulpes
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Re: Principles for the Valuation of Hedge Fund Portfolios

Dear Ms. Vulpes,

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre" or the "Centre")[1], in consultation with the 11 volunteer professionals on its Capital Markets Policy Council (the "CMPC"), is pleased to comment on the consultation of the International Organization of Securities Commissions ("IOSCO"), *Principles for the Valuation of Hedge Fund Portfolios* (the "Consultation"). The CFA Centre represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the efficiency and integrity of global financial markets.

Summary and Interpretation of Consultation

IOSCO proposes nine principles relating to hedge fund valuations. The Principles are:

1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund.

2. *The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund.*

3. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.

4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.

[1] The CFA Institute Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, Virginia, USA, and regional offices in London, Hong Kong, and New York, CFA Institute, is a global, non-profit professional association of nearly 91,500 financial analysts, portfolio managers, and other investment professionals in 134 countries and territories of which more than 78,200 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 134 Member Societies and Chapters in 55 countries and territories.

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5. The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed

6. The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and in particular of any valuation that is influenced by the Manager.

7. A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party.

8. The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.

9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.

As referenced in the Consultation, IOSCO is aware of the CFA Institute Centre's *Asset Manager Code of Professional Conduct* (the "AMC"). The AMC outlines the ethical and professional responsibilities that fund managers owe to their clients and sets standards for asset management firms and their conduct. It considers firms' relationships with clients, the investment process, trading, compliance and support, performance and valuation, and disclosure. The portions of the AMC dealing with the valuation of hedge fund portfolios are included in Section E ("Performance and Valuation"), Section F ("Disclosures"), Section B ("Investment Process and Actions"), and Section D ("Compliance and Support").

The Principles do not conflict with the standards set in the AMC. To the contrary, the Principles supplement the suggested conduct relating to valuation in the AMC with more detail specifically relating to the valuation of fund portfolios.

Consequently, the CFA Institute Centre supports the Principles as drafted by IOSCO and their implementation by hedge funds. However, in the comments below, the Centre makes suggestions on how IOSCO should modify the Principles to ensure goal of providing consistent, understandable, and transparent valuations is achieved.

General Comments about the Consultation

Unlike traditional investment funds, hedge funds make use of a wide variety of investment instruments. On the one hand, they invest in liquid, publicly traded equity or fixed-income securities or exchange-traded derivatives ("Quoted Securities") whose price quotes are readily available from a number of public sources. Increasingly, though, hedge funds also make use of complex, illiquid, and often one-of-a-kind financial instruments such as over-the-counter derivatives, contracts for difference, private equity interests, venture capital, and thinly traded exchange traded derivatives, equity securities, and bonds, not to mention bank loans and other sources of leverage (collectively, "Negotiated Instruments"). It is these Negotiated Instruments which pose the greatest appraisal risk for investors, counterparties, and regulators, alike, and create the most difficulty for those individuals and firms involved in the valuation of such instruments (the "Appraisers").

The valuation procedures proposed in the Principles are needed, IOSCO notes, because of the sector's significant role in providing liquidity and innovation to global capital markets. Such valuations are also important, however, for determining the compensation of fund managers and, even more importantly, the solvency of the funds and their influence on the financial condition of counterparties.

The CFA Institute Centre believes that any valuation of Negotiated Instruments should include the disclosure of four elemental valuation considerations (the "Four Elements"): 1) the models used; 2) the assumptions employed; 3) the investment instruments being appraised; and 4) the structure underlying the appraised investment instrument. Investors and counterparties need disclosures about these elements to independently assess portfolio values, financial condition, and risks accepted by dealing with these funds.

The Principles call for disclosure of some of these considerations. For example, Principle 2 calls on funds to disclose the models and inputs used. However, it is imperative that funds also disclose and discuss the nature of the instrument and of the underlying structure if investors and counterparties are to understand the risks involved and assess the viability of the assigned valuations.

The CFA Institute Centre also is concerned that the Principles may be interpreted as a one-sided approach to valuation of financial instruments used by hedge funds. Specifically, the implication carried throughout the Consultation is that it is concerned with the valuation of financial instruments that are held as assets on the balance sheets of the funds; there is no mention of the valuation of instruments that create liabilities for the funds. To this end, the Centre suggests that IOSCO modify the Principles to calls on funds' governing bodies to direct third-party or in-house Appraisers to consider the valuation of debt instruments employed by the fund in order to provide a more accurate picture of a fund's financial condition.

Finally, while recognizing IOSCO's wish not to create a document that dictates how valuations are created, the CFA Institute Centre believes that IOSCO should include in its guidance a hierarchy of valuation methods. In particular, Appraisers should look to public quotations as the best proxy of value for Quoted Securities. When quotations are not readily available, they should call for the use of widely accepted valuation techniques and methods. And only in those cases where traditional valuation techniques and methods are not applicable should Appraisers use proprietary valuation models. In both of the latter two situations the Principles should call on funds to disclose the Four Elements discussed above.

In the paragraphs that follow, the CFA Institute Centre provides responses to the specific questions raised by IOSCO in the Consultation.

Specific Questions

Question 1: What is your opinion of each of the Principles?

In general, the CFA Institute Centre supports the use of the policies and disclosures contained in the Principles. It is anticipated that the Principles will promote investor understanding about the valuation of illiquid financial instruments.

However, it is reasonable to interpret Principle 2 and its related guidance as not seeing one valuation methodology as superior to any other. In particular, the supporting guidance to the Principle calls for funds merely to disclose, among other things, "the selection criteria for pricing and market data sources." It continues by stating that the "selection process for a particular methodology should include an assessment of the different relevant methodologies that are available by appropriately qualified and experienced parties."

As stated above, the CFA Institute Centre believes IOSCO should at least suggest in the guidance to the Principles a hierarchy of valuation methods beginning with readily available market quotations for Quoted Securities. When dealing with Negotiated Securities where quotations are not readily available, the Principles should call upon Appraisers to use widely accepted valuation techniques and methods. Finally, in those cases where it is not possible to use traditional valuation techniques and methods, the Principles should call for full disclosure of how the valuation model works and any assumptions included, and describe both the instrument valued and the structure underlying the instrument. Only with this information will investors and counterparties be able to determine the appropriateness of the valuations and the appropriateness of transacting with the fund.

Question 2: Has IOSCO correctly identified the challenges inherent in the valuation of hedge fund financial instruments?

The CFA Institute Centre believes the challenges IOSCO has identified are relevant and inherent in valuation of hedge fund portfolios. As noted in its suggestions above, the CFA Institute Centre believes the challenges also include consideration of the value of the fund's liabilities and an understanding of the structures underlying the investment instruments used.

Question 3: Has IOSCO correctly addressed those challenges?

One specific challenge that IOSCO identifies in the "drivers" of IOSCO's focus on hedge fund portfolio valuation but doesn't address in the Principles is the issue of conflicts of interest. While Principles 5 and 6 deal with one aspect of this issue by requiring "independence" in applying the recommended policies and procedures and in the review of the values generated, there is little to direct hedge funds, their managers, and their governing bodies on the need to manage such conflicts.

The CFA Institute Centre believes hedge funds should identify and consider the real and potential conflicts of interest in their businesses and manage them on an on-going basis. In part this requires fund managers to have policies and procedures to ensure adherence to their legal, regulatory, and ethical obligations, the valuation of their portfolios, and management of any conflicts of interest, among other things. It also requires funds to appoint compliance officers to administer those policies and procedures. Finally, it requires managers to disclose its conflicts of interest, including those inherent in their valuation procedures or with any of the Appraisers they may hire. Such disclosures should be made prominently, clearly, and in close proximity to disclosures relating to valuations provided by third parties.

An additional challenge not specifically addressed is the valuation of any instruments creating leverage for the fund. These instruments include, among other thing, margin accounts, borrowed share accounts, outstanding debt and credit facilities, and any other instruments of leverage. The Centre suggests that IOSCO include in its guidance to Principle 1 a call for application of valuation policies and procedures to instruments creating leverage.

Question 4: In what way could the Principles be amended to further benefit investors in hedge funds?

Please see the suggestions provided above in response to Questions 1 and 3 above.

Question 5: Are there material obstacles to the implementation of the Principles within hedge funds?

In general, application of these Principles will depend on the interest and ethical bearings of the hedge fund, hedge fund manager, and, to a lesser extent, the fund's governing body. Moreover, even if a fund manager were to advertise its adoption of the Principles, enforcement will remain difficult.

To overcome this concern, IOSCO and its members could permit hedge funds to cite adherence to the Principles as a means of indicating an ethical and verifiable approach to portfolio valuation. To receipt such sanction, funds would have to make their valuations verifiable to either local regulatory authorities or respected and independent third parties. In such situations, receipt of such an imprimatur could enhance the marketability of the fund and the manager to other investors. The loss of such recognition, on the other hand, could lead to the fund not having access to certain investment funds of entities such as pension funds, and thus potentially create a need for compliance with the Principles.

Question 6: Are there additional Principles that would benefit hedge fund investors?

Please see the suggestions provided above in response to Questions 1 and 3 above, and under "General Comments Regarding the Consultation."

Question 7: What, if any, additional specific measures should be incorporated within the policies and procedures to enhance the Principles?

As noted in the response to Question 5, the CFA Institute Centre suggests that IOSCO and its members permit hedge funds to cite adherence to the Principles where verifiable. The goal is to enhance the marketability of funds and managers complying to the Principles.

Concluding Comments

The Centre appreciates the opportunity to comment to IOSCO on its consultation, *Principles for the Valuation of Hedge Fund Portfolios*. If you or your staff have questions or seek clarification of our views, please feel free to contact James C. Allen, CFA, at +1.434.951.5558 or james.allen@cfainstitute.org.

Sincerely,

/s/ Kurt Schacht
Kurt Schacht, CFA
Managing Director
CFA Centre for Financial Market Integrity

/s/ James C. Allen
James C. Allen, CFA
Senior Policy Analyst
CFA Centre for Financial Market Integrity

Centre for Financial Market Integrity

Ms. Pamela Vulpes
IOSCO General Secretariat
Re: Principles for the Valuation of Hedge Fund Portfolios
21 June 2007

CFA Centre for Financial Market Integrity
Capital Markets Policy Council
Volunteer List

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Senior Vice President
Lombard Odier Darier Hentsch & Cie
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European Banking Federation
Secretary General

H7115BEH
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EBF ref.: 0465

Brussels, 21 June 2007

Ms. Pamela Vulpes
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain
Pamela@iosco.org

Subject: Principles for the Valuation of Hedge Fund Portfolios

Dear Ms. Vulpes,

The European Banking Federation[1] (EBF) welcomes the opportunity to comment on the IOSCO's consultation report on principles for the valuation of hedge fund portfolios. We welcome the work undertaken in this area and see the IOSCO's proposals as an important step towards increased transparency around hedge funds, while relying on the principle on industry self-regulation.

We agree with both the IOSCO's description of the economic background and evolution of the hedge funds market and its assessment regarding the importance of the valuation of hedge fund portfolios, as well as the related difficulties. The correct valuation of portfolios is an important factor for good risk management on the micro-economic level and has thereby also indirect implications on the macro-economic level and on international financial stability. Furthermore, portfolio valuation bears a potential risk of conflicts of interest between investors and fund managers.

The EBF also expects that the IOSCO's recommendations will be well suited to enhance the valuation of positions in illiquid markets and of complex instruments and to thereby address these difficulties. Moreover, we are particularly supportive of the proposed principles as they correspond to and have already proven their viability in the good practices exercised by internationally active institutions. It is in our view consistent to promote similar standards for the hedge fund counterparties of these institutions.

We finally wish to suggest that the principles for the valuation of portfolios be supplemented with principles for the risk management of hedge funds.

We hope that you will find these comments helpful and look forward to continuously working with the IOSCO on these and other issues relevant to the banking industry.

Yours sincerely,

Guido RAVOET

[1] The European Banking Federation (EBF) is the voice of the European banking sector representing the vast majority of investment business carried out in Europe. It represents the interests of over 5,000 European banks, large and small, from 31 national banking associations, with assets of more than €20,000 billion and over 2.3 million employees.

Ms Pamela Vulpes
IOSCO General Secretariat
c/ Oquendo 12
28006 Madrid
Spain

Dear Ms Vulpes

Re Principles for the Valuation of Hedge Fund Portfolios

The Irish Funds Industry Association (IFIA) is the industry organisation for the investment fund community in Ireland, which includes the custodian banks, administrators, managers, transfer agents and professional advisory firms. Given that in excess of €600bn in over 4000 hedge/alternative investment funds are serviced by the industry in Ireland all considerations with respect to the valuation of hedge fund assets and portfolios are of particular interest and relevance to the Irish industry.

The IFIA welcomes both the publication of and the opportunity to comment on the consultation report issued by the Technical Committee of the International Organisation of Securities Commissions ("IOSCO") on principles for the valuation of hedge fund portfolios. Our comments on the consultation report are as follows:

- We believe that the nine principles identified in the report are appropriate and comprehensive.
- We believe that the report has identified the most significant challenges inherent in the valuation of the types of investments into which hedge funds can invest.
- The report provides an appropriate foundation on which detailed policies and procedures could be developed by individual hedge funds. The operation of hedge funds can vary depending on factors such as, inter alia, the jurisdiction and regulation of the fund, the size of the investment manager, the complexity of the investments, the use of third party service providers and the number of investors. Principles for the valuation of hedge fund portfolios need to be flexible in order to be effective and need to consider the circumstances of the particular fund for which they have been designed. We believe the report acknowledges the need for this flexibility and that a 'one size fits all' approach would not be effective.
- There could, in certain circumstances, be practical obstacles to the implementation of these principles. These obstacles include:
    - The implementation of some aspects of the principles will only be achieved with the appropriate operational infrastructure. For example, in order to achieve the appropriate level of independence in the pricing process many hedge funds will either have to employ additional back office staff or rely more heavily on third party suppliers. The cost of implementing an enhanced operational infrastructure will be most heavily felt by the smaller hedge fund managers.
    - Many managers of hedge funds are small organisations that are primarily focused on the implementation of the fund investment strategy. Many of them have a small number of staff and this can restrict their ability to achieve segregation of duties within the manager. This characteristic could prove to be a practical obstacle to ensuring that there is an appropriate level of independence in the valuation process.
    - The implementation of a valuation committee, which would include a member independent of the manager, or the enhancement of the operation of the governing body could in certain circumstances be difficult to implement unless the people with the appropriate technical skill and experience can be found for these roles. The paper suggests that there is a number of ways to ensure a high level of independence is brought to bear in the application of the

valuation policies and procedures. It may, in the case of smaller managers, result in the use of third party providers as, in practice, it will be difficult to attract the appropriately qualified people to be active in independent roles.

We believe the report to be of value to the hedge fund industry and we look forward to seeing the final version.

With kind regards
Yours sincerely

Gary Palmer
IFIA

INVERCO REPLY TO THE IOSCO CONSULTATION REPORT ON PRINCIPLES FOR THE VALUATION OF HEDGE FUNDS PORTFOLIOS

1.- INTRODUCTION

INVERCO, the Spanish Association of Collective Investment Schemes and Pension Funds, represents more than six thousands collective investment schemes and almost a thousand pension funds, with more than EUR 416 billions in assets under management.

INVERCO congratulates IOSCO for its constant effort to promote the best practices in the financial market and welcomes the present consultation on the valuation of hedge funds.

Accordingly, INVERCO strongly supports the Principles 1 to 8 proposed by IOSCO. Furthermore, they fit perfectly the legal framework recently enacted for the governance of (funds of) hedge funds in Spain. However, the proposed principle regarding transparency (Principle 9) could be, to a certain extent, excessively strict.

2.- COMMENTS ON PRINCIPLE NINE *("TRANSPARENCY")*

INVERCO shares the view that the existence and implementation of clear, comprehensive and documented policies and procedures for the valuation of the financial instruments of the hedge funds are made in the interests of the investors and, therefore, the development of a sound industry of hedge funds.

In INVERCO'S opinion, disclosure to investors should be focussed on the basic characteristics of the (funds of) hedge funds and their risks and costs, so that they can decide what best suit their needs. The standard should be based on Article 19 of MIFID, according to which the information to be provided to investors will be directed to in a reasonable manner allowing them a proper understanding of the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, therefore, the adoption of investment decisions on an informed basis.

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The same goal inspires the European Commission's proposal on simplifying the Simplified Prospectus and the investor disclosure regime, which tends to the removal of all the irrelevant information.

Nevertheless, not all the information mentioned in Principle 9 serves this purpose.

Consequently, INVERCO agrees that each and every one of the items listed in Principle 9 should be documented by the management company and be available to the national supervisor, depositary and/or auditor, according to the terms envisaged in their domestic rules, but ***not necessarily provided to the investor, since such provision***, although should only take place "upon request", ***forces the management company to design an structure and procedures to meet the potential demand of information and therefore involves a considerable overhead for the hedge fund industry***.

As the goal of the IOSCO's consultation is to set out a number of principles to be "*applicable across a wide range of jurisdictions*", the successful definition of those principles should take into account that, in a large number of jurisdictions, the information suggested on principle 9 is already produced by the management company, and two levels of disclosure are envisaged:

- the most general aspects regarding assets valuation are included in the prospectus and supplied to the investors;

- the most technical points are described in the internal procedures and provided to the national supervisor as a requirement for the management company to obtain the license. Likewise, the aforementioned information will be at the supervisor, depository and/or auditor disposal, in the exercise of their respective functions.

According to INVERCO's view, the regime for the information on assets valuation should be based on the following points:

- General asset valuation criteria should be set out in the hedge fund ***prospectus***, which must be delivered to the ***investor*** prior to the investment.

- In order to be authorized, the management companies must state, in their internal control procedures, the qualitative, quantitative and operational criteria

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for the assessment and analysis of the investments for the institutions they manage. Those criteria, which must include in detail procedures for valuing assets and calculating the net asset value, shall be agreed upon with the depositary and must be approved by the Board of Directors of the management company and by a person with sufficient authority at the depositary. They will be ***at disposal of the national supervisor, auditor and/or depositary***, for the exercise of their respective oversight functions.

- ***Participation of the management company in the valuation*** of the hedge fund assets must be exceptional, and when such participation is necessary, it ***shall be documented and the documentation retained for oversight purposes*** (national supervisor, auditor and/or depositary), but not available to every investor.

In conclusion, it is a fact that investors have to receive clear and focused information to understand the main features of their investment, but the benefits for the clients are not proportional to the amount of information received. ***Too much information can confuse, and indeed detract from, the key messages.*** So, ***disclosure should be confined to the information that allow the investors to understand the characteristics of their investment, keeping the most complex and technical details for those specialized bodies whose statutory functions include to verify compliance with the binding rules and/or the best practices in portfolio's valuation.***

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To: Technical Committee of the International Organization of Securities Commissions (IOSCO)

From: Various Participants of the London Buy Side Forum (see below)

Subject: Feedback on the Consultation Report 'Principles for the Valuation of Hedge Fund Portfolios'

Date: 18th June 2007

Introduction

The Buy Side Forum met for the first time on 20th February to address a number of industry wide operational issues. The Forum agreed that the highest priority group of issues centred on Month End Valuations, as this was the greatest risk to issuing timely and accurate information to investors, and thereby maintaining confidence in the alternative and conventional investment industries.

Given the potential impact that the IOSCO report (and subsequent guidance) is likely to have on valuation processes for the participants of the forum, it has been decided to provide feedback on the report - specifically re the nine proposed principles and their appropriateness and practicality.

Feedback

We understand and acknowledge that it is difficult to construct guidelines that can be applied across such a diverse international industry, and so believe that the challenges have been addressed at the right level – ie at a level high enough such that the general principles can be applied, without being so general that they become meaningless.

Addressing each of the principles in turn:

1) **Comprehensive, documented policies and procedures should be established for the valuation of financial instruments**

Feedback: Overall we agree that for any valuation policy to work, it needs to be sufficiently documented.

The only issue we would highlight is with regard to 'valuation time'. Any fund using counterparty marks in their valuations process would have difficulty in valuing a portfolio at a specific time across every counterparty, as this is just not practical with banks all closing their books at different times. This also applies to prices provided by third party vendors, eg MarkIT, where prices are contributed from banks. We think it would be appropriate for the guidance to address this issue.

2) **Policies should identify methodologies for valuing all the funds' instruments**

Feedback: Overall agreement on this, however for what is probably the most complex area of the process, the examples used (ie acceptable inputs, independent sources, cut-off times) are very general and do not go into sufficient depth on the subject. We would expect to see more detail on the characteristcs that appropriate methodologies would contain – what would be expected, in particular regarding single sources, where the only comment is that there should be a validation procedure, with no guidance as to how this can or should be achieved. There is in fact more analysis on this in the sixth principle re independence.

Also, how realistic is it to build a framework for instruments that have not yet been traded, given the dynamic nature of the hedge fund environment ?

Similarly, how practical is it for the policies to deal in advance with products that fall outside of the valuation policy, as it will depend on the product type traded – size, risk, etc.

In all, this principle and its associated guidance appears to be drafted at too high a level to provide an effective tool for a Governing Body or fund investor.

3) **Valuations should be consistently determined according to the policies and procedures**

Feedback: This principle relies on adequate reporting to the Governing Body. In the case of UK managers this is likely to be the board of directors of the fund which may not be realistic or practical. For example, is discussion at quarterly board meetings sufficient? How well placed will the Governing Body be to be able to monitor consistency in the first place? The Committee may wish to consider that consistency should be monitored by appropriate independent parties within the hedge fund manager on a monthly basis with summary feedback to the Governing Body on a less frequent basis (eg at board meetings).

In addition, the requirement for consistency across hedge funds of the same manager could lead to inappropriate valuation methodologies being used. If it is acceptable for two different fund legal entities managed by different Investment Managers to pursue different valuation methodologies for the same asset why would it not be acceptable if the two fund legal entities had the same Investment Manager?

4) **Policies and Procedures should be reviewed periodically**

Feedback: The committee may wish to propose that policies and procedures also be agreed, upfront, with both a third party administrator and the fund's auditors as best practice.

5) **Governing Body should ensure a high level of independence and experience in the application of the policies and procedures**

Feedback: As per the third principle, there is potential over reliance on the Governing Body . Many directors on the board are not involved in the day to day operations of the business (for the very reason of independence), and therefore are not necessarily well placed to analyse the experience of those involved in the valuation process, or the processes themselves.

Also, the report refers to a valuation committee, but does not elaborate on who this might consist of. In a small fund manager for example, how practical is the forming of a valuation committee which is independent from the valuation process?

The committee may wish to re-consider these issues.

6) **Independent review of valuations generated, and procedures for any manager-influenced valuation**

Feedback: Is the recommendation overall therefore that a hedge fund needs an actively involved governing body, a valuation committee, an independent party, and a segregation of duties? This is probably not practical for a small hedge fund manager.

As with point 4 we would propose that the policy and procedures for valuing high risk items be agreed up front with the fund's auditors.

7) **Policies and procedures should describe process for handling and documenting price overrides**

Feedback: It is agreed that exception reporting and tracking is of high importance to the integrity of the valuations.

8) **Governing Body should conduct periodic due diligence on third party valuation services**

Feedback: Regardless of any due diligence performed, many administrators have limitations with respect to their ability to be able to price hedge fund portfolios – they are removed from the business, do not have access to trading analytics, and may have a weak pricing function. This report would be much more valuable if hedge fund administrators also had to sign-up to the relevant principles of which they form a key part, given that they are often the independent party who is producing the fund's NAV.

Also, it is more likely to be the manager conducting the due diligence. The Governing Body should obviously review the findings, and approve the choice of any new third party provider.

9) **Valuation arrangements should be transparent to investors**

Feedback: It is agreed that the valuation process should be as transparent as possible to all fund investors.

Other Comments

Overall the challenges have been identified well, however some additional points have been highlighted below.

One area it is felt perhaps overlooked or underestimated is the outsourcing of valuations to a third party provider (i.e. administrator). In the UK at least, this is the majority practice as investors like to see this approach to independence. In an ideal world a hedge fund manager could simply leave an administrator to price the portfolio. However the reality is that the valuation services provided by most administrators is of poor quality, and often requires input, or detection of error, by the manager. Administrators have limited expertise and information available to them, and so, while able to offer a degree of independence, cannot necessarily be relied on to produce a full set of portfolio valuations without intervention. For this set of principles to really add value, they would need to be something that an administrator should aim to comply with as well.

There is a heavy reliance on the Governing Body (in the form of directors). In many instances the directors will not be involved in day to day running of the fund, and they also may not have the appropriate valuation expertise to be able to make the necessary decisions. A valuation committee should be a sufficient substitute, as appropriately constituted by the Governing Body

Where pricing is performed in-house by administrators using their own models, an independent model review may be impractical, and alternatives should be sought (e.g. write-up of their testing), or valuations compared against alternative sources.

There is focus on the valuation of complex, illiquid, or single source positions. However there have been numerous instances over recent years where non-complex, liquid, vanilla products have been the cause of certain failures or shortcomings in the hedge fund community and the Committee should ensure these issues are adequately discussed within the guidance.

The recent AIMA guidance went into further detail on some of the valuation issues that can arise, as well as touching on the need for any valuation policy to be practical to implement. The Committee would benefit from incorporating these elements into the final principles.

Footnote 7 refers to many exclusions from the coverage of the report (eg timely disclosure of NAV, valuation of investments in other funds, compliance with accounting standards). These can be material to many hedge funds, so IOSCO should aim to include these in the final report or to develop further guidance in this area as soon as is practical.

Finally, we would re-iterate that the Committee's Consultation Report is a good attempt to address a complex set of issues that is being addressed by a wide variety and types of entity across a number of regulatory jurisdictions. We applaud the inclusion on the Committee of representatives of the hedge fund industry. We would urge the Committee to make all reasonable efforts to ensure the final Principles and any associated guidance is consistent with the recently issued AIMA "Guide to Sound Practices for Hedge Fund Valuation".

Yours sincerely

BlueCrest Capital Management Limited
GSA Capital Partners LLP

MANAGED FUNDS ASSOCIATION

VIA ELECTRONIC MAIL: p.vulpes@iosco.org

June 21, 2007

Ms. Pamela Vulpes
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

Re: Consultation Report on Principles for the Valuation of Hedge Fund Portfolios (March 2007)

Dear Ms. Vulpes:

Managed Funds Association ("MFA") appreciates the opportunity to comment on the above-referenced IOSCO Consultation Report ("IOSCO Report"). Apart from providing specific comments to the IOSCO Report, this letter also provides information to IOSCO regarding the role of MFA in representing the interests of the hedge fund industry and to stand as a resource for IOSCO regarding our policy work. These written comments to the IOSCO Report supplement remarks I delivered at IOSCO's 2007 32nd Annual Conference held in Mumbai, India earlier this year.[1]

MFA commends IOSCO on its efforts to provide guidance on the topic of valuation of investments held by hedge funds. MFA generally agrees that a global set of principles in this area is critical given the potential for conflicts of interest between a hedge fund manager and hedge fund investors. MFA acknowledges that the primary goal of the IOSCO Report is to set forth principles to guide hedge fund management[2] in connection with the valuation of their investment portfolios. Overall, MFA generally agrees with these principles and finds that they are, by and large, consistent with MFA's approach to sound practices in this area, as explained more fully below.

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[1] Speech by John G. Gaine, "Hedge Funds – New Regulatory Challenges: An International Perspective," delivered at the IOSCO 2007 32nd Annual Conference, Mumbai, India (April 12, 2007) (a copy of which is available at MFA's Web site: www.managedfunds.org).

[2] In this letter, there are references to both "hedge fund management" and "hedge fund managers." The different usage of these terms is not unintentional. MFA recognizes that the IOSCO Report places primary responsibility on hedge fund management (i.e., the governing body of a hedge fund, a hedge fund manager, or both, depending on the jurisdiction in which a hedge fund is formed) to implement its principles. The intended audience of the IOSCO Report is understandable given that it addresses macro-level principles. *MFA's Sound Practices* (as defined below) are, however, addressed to hedge fund managers specifically because *MFA's Sound Practices* are focused on day-to-day operational practices of hedge funds.

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MFA Background

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media, and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.5 trillion invested in absolute return strategies.

MFA's activities include several public and private sector initiatives affecting the hedge fund industry in the United States and internationally. With respect to the public sector in the United States, MFA undertakes educational outreach to and representation before the Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Reserve, Treasury Department, state agencies and Congress. MFA participates in a number of private sector initiatives, as well. Most notably, MFA has published *MFA's 2005 Sound Practices for Hedge Fund Managers* ("*MFA's 2005 Sound Practices*")[3] and is in the process of publishing an upcoming update thereto, *MFA's 2007 Sound Practices for Hedge Fund Managers* ("*MFA's 2007 Sound Practices*," and when herein referenced together with *MFA's 2005 Sound Practices*, "*MFA's Sound Practices*"). Moreover, MFA participates in other private sector efforts, such as working with the 18 major dealers in improving derivative market practices. As highlighted above, MFA also represents the views of the hedge fund industry before international advisory and governmental bodies such as IOSCO, the United Kingdom's Financial Services Authority, and the Securities Exchange Board of India.

MFA's Sound Practices & Comments to the IOSCO Report

As stated in my speech in Mumbai this year, MFA believes the nine principles recommended in the IOSCO Report are not inconsistent with the practical recommendations developed for the hedge fund industry in *MFA's 2005 Sound Practices*.

By way of background, *MFA's 2005 Sound Practices* makes several recommendations for the benefit of the hedge fund industry and covers key topics that are intended to promote sound business practices for hedge fund managers and, in doing so, enhance investor protection while contributing to key market soundness. The recommendations contained in *MFA's 2005 Sound Practices* are divided among the following seven topics:

- Management and Internal Trading Controls;
- Responsibilities to Investors;

[3] See www.managedfunds.org.

- Valuation Policies and Procedures;
- Risk Monitoring;
- Regulatory Controls;
- Transactional Practices; and
- Business Continuity and Disaster Recovery.[4]

At the time of submitting this letter, MFA is in the process of drafting *MFA's 2007 Sound Practices*. Publication of this document will continue MFA's mission of making its recommendations applicable to a broad range of hedge fund managers globally, in light of evolving industry practices. In drafting *MFA's 2007 Sound Practices*, MFA is taking into account the latest developments in investment practices by hedge fund managers, as well as the current regulatory environment. It is noteworthy that *MFA's 2007 Sound Practices* will reference the U.S. President's Working Group on Financial Markets' ("PWG") "Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital," published in February 2007. The past and upcoming editions of *MFA's Sound Practices* are consistent with public sector calls to improve market discipline. The *2007 Sound Practices* will update and expand treatment of topics important to the global hedge fund industry, including internal trading controls, responsibilities to investors, risk management, regulatory controls, transactional practices, business continuity and disaster recovery, and, of course, valuation.

We believe *MFA's Sound Practices* are comprehensive and promote standards of excellence for the hedge fund industry. Similar to the IOSCO Report, a central theme emphasized in *MFA's Sound Practices* is to stress that "one-size does not fit all" when it comes to evaluating our recommendations to hedge fund managers.

With respect to the subject of this letter, MFA considers the valuation principles recommended in the IOSCO Report as providing macro-level guidance to hedge fund management, whereas *MFA's Sound Practices* provides an operational framework of practical recommendations to hedge fund managers. Stated differently, both documents reach the same conclusions, but offer guidance on different levels of detail: one is broader in scope (IOSCO's principles), while the other focuses on aspirational management that goes beyond any law or regulation and is written from a peer-to peer perspective (*MFA's Sound Practices*).

The IOSCO Report requests that public comments to the paper come in the form of responses to seven questions. Accordingly, we have set forth our comments below in the manner requested.

[4] In addition, there are five substantive appendices that supplement the recommendations in the seven substantive areas listed above, which cover: (1) Risk Monitoring; (2) U.S. Regulatory Filings; (3) Anti-Money Laundering; (4) Checklist for Compliance Manuals; and (5) Checklist for Code of Ethics.

1. **What is MFA's opinion of each of the principles?** MFA concludes that the nine principles are not inconsistent with *MFA's Sound Practices*. The following discussion addresses each principle specifically.

   <u>Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund</u>. *MFA's Sound Practices* similarly provides that written policies and procedures in terms of valuation is a critical element to achieve consistency, independence and transparency.

   <u>The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund</u>. *MFA's Sound Practices* specifically recommends that where market prices for an instrument are readily available from organized exchanges for markets or recognized data vendors, a hedge fund manager should use such market prices to determine the instrument's value. In situations where market prices are not readily available, *MFA's Sound Practices* recommends that a hedge fund manager determine the methods to be used in obtaining values from alternative sources.

   <u>The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedure</u>. Section 3.2 of *MFA's 2005 Sound Practices* goes a step further than this principle and provides that a hedge fund manager should seek to utilize valuation practices so that the hedge fund is consistent and fair to both subscribing and redeeming hedge fund investors, to the extent practicable, and makes appropriate disclosures of circumstances in which practices may necessarily deviate from this standard in a material way.

   <u>The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness</u>. *MFA's Sound Practices* agrees with this principle and suggests methods for reviewing valuation policies and procedures based on whether the instrument is actively traded, or is less liquid or infrequently traded. *MFA's Sound Practices* also suggests that hedge fund managers update valuation policies and practices from time to time, to gauge accuracy and fairness.

   <u>The governing body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed</u>. MFA agrees with this principle in that independence is paramount given the potential for conflicts of interest in the valuation of financial instruments by hedge funds. Specifically, sections 3.3 and 3.4 of *MFA's 2005 Sound Practices* recommend to hedge fund managers that they develop practices and systems for capturing data from independent sources on a daily basis, where practicable, and that they determine methods to obtain values from alternative sources, with reliability, stability and independence being among the main criteria.

The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and in particular of any valuation that is influenced by the hedge fund manager. Again, *MFA's 2005 Sound Practices* agrees with the principle of independence in light of potential conflicts of interest. Section 2.3 of *MFA's 2005 Sound Practices* provides that a hedge fund manager should assess whether its operations or particular circumstances may present potential conflicts of interest and seek to ensure that any conflicts of interest that may be material are appropriately disclosed and that controls are in place to address them.

A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an independent party. *MFA's Sound Practices* is consistent with this principle in that *MFA's Sound Practices* explicitly recommends that a hedge fund manager fully document the process it uses to determine whether to override a pricing service's recommendations regarding the valuation of a financial instrument.

The governing body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services. MFA also agrees with this principle and expands it to apply to "mission-critical," third-party service providers, which perform key business functions (including pricing and valuation). Indeed, sections 1.5 and 3.7 of *MFA's 2005 Sound Practices* provide that a hedge fund manager should carefully select third-party service providers based upon their experience and consistently perform diligence to determine if these providers maintain expected levels of service.

The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors. *MFA's Sound Practices* goes into greater detail than the IOSCO Report with respect to the issue of transparency. In particular, *MFA's Sound Practices* provides that a hedge fund manager should provide information regarding the hedge fund's valuation policies and practices, investment objectives, strategies and range of permissible investments to prospective and existing investors.

2. **Has IOSCO correctly identified the challenges inherent in the valuation of hedge fund financial instruments?** MFA acknowledges and views as accurate the following five challenges identified in the IOSCO Report, which are faced by hedge fund management relating to financial instrument valuation: (a) the increasing importance of hedge funds to global capital markets; (b) the complexity of some hedge fund portfolio strategies and their underlying instruments; (c) the central role of financial instrument valuations to hedge funds; (d) conflicts of interest that can

exacerbate valuation difficulties; and (e) how the jurisdiction of organization of a hedge fund causes differences in hedge fund strategies.

3. **Has IOSCO correctly addressed those challenges?** MFA commends IOSCO for accurately and adequately addressing the five challenges discussed above. It is our view that hedge funds can use IOSCO's principles in conjunction with *MFA's Sound Practices* since both documents are not inconsistent with one another.

4. **In what ways could the principles be amended to further benefit investors in hedge funds?** As mentioned previously, MFA finds that IOSCO's principles regarding valuation adequately address the challenges discussed above. As the hedge fund industry matures and new questions emerge, it may then be necessary for IOSCO to amend its principles. Nonetheless, MFA feels that the principles as set forth in the IOSCO Report are sound.

5. **Are there material obstacles to the implementation of the principles within hedge funds?** While disparities among hedge fund participants may present a challenge in respect of the application of the principles set forth in the IOSCO Report, MFA does not feel that this rises to the level of a material obstacle, which will prevent their implementation in and acceptance by the hedge fund industry generally. Industry participants vary greatly in terms of the number of personnel, amounts of assets under management and investment strategy. The IOSCO Report, like *MFA's Sound Practices*, correctly identifies, however, that "one size does not fit all."

6. **Are there additional principles that would benefit hedge fund investors?** MFA believes that IOSCO's principles and *MFA's Sound Practices* provide hedge fund investors with sufficient guidance in which to evaluate for themselves an investment in a hedge fund.

7. **What, if any, additional specific measures should be incorporated within the policies or procedures to enhance the principles?** MFA does not suggest that additional specific measures be incorporated within the policies or procedures to enhance IOSCO's principles. As mentioned elsewhere in this letter, MFA understands that IOSCO's principles are intended to provide guidance at a macro-level. If IOSCO were to provide more specific measures or practices with respect to the valuation of financial instruments, this may create conflicts with *MFA's Sound Practices,* and as a result, cause confusion within the hedge fund industry, which generally accepts and incorporates *MFA's Sound Practices* in their operations.

As aforementioned, MFA is in the process of drafting *MFA's 2007 Sound Practices.* While still in its initial drafting phase, the new recommendations applicable to valuation of the hedge fund portfolios will be within the broader context of guiding principles for determination of net asset value. The recommendations in this section will likely be organized into three key areas. The first set of recommendations will cover verification of financial assets and liabilities, and will include the concept of fair value. The second set of recommendations will cover valuation policies and procedures, including, but not limited to, pricing policies and sources, valuation of instruments and price validation. Finally, the third set of recommendations will address the financial statement close process.

While the three areas discussed in the preceding paragraph are not a comprehensive list of the subjects that will be covered in *MFA's 2007 Sound Practices*, we are happy to provide a foreshadowing of what is to come. Once MFA's *2007 Sound Practices* are published, we may take the opportunity to update the comments in this letter.

Conclusion

MFA hopes that members of IOSCO's Standing Committee 5 (of its Technical Committee) and other IOSCO members' interested in hedge fund industry issues review *MFA's Sound Practices* for further guidance. We welcome the opportunity to meet with you and act as a resource of information as you continue to evaluate hedge fund industry issues. For additional information, you may reach me at (202) 367-1140.

Sincerely,

John G. Gaine

John G. Gaine
President

Dear Ms Vulpes,

I found the IOSCO consultation report on “Principals for Valuation of Hedge Fund Portfolios’ very interesting. I noted you invited the public to comment on your report. In my role I reviewed over a hundred hedge Funds and in my view the following issues should also be addressed:

? The role of the administrators; I think the Report should attempt to define best practice around “independent review” of administrators.
? The role of counterparty prices; many Funds use counterparty statements even though the counterparty is very likely to carry conflicting interests in valuing securities.

? Finally, in my view, it is important to address the role of the Board of Directors in ensuring relevant and consistent valuation is used. The report should, in my opinion, should also lay a best practice procedure for the Board to follow, for example, setting up a valuation committee with a majority of members being independent and expert in the securities at question.

I hope you will find the above points useful.

Best regards,

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From: strategy [mailto:strategy@sec.or.th]
Sent: Thursday, May 24, 2007 7:02 AM
To: Pamela Vulpes
Cc: ทิพยสุดา ถาวรามร; วิภาดา ศิริเจริญ; พัสนันท์ มณีรัตน์; ดวงมน จึงเสถียรทรัพย์; อุษณา ชะนะมา; มยุรี ผาสุพันธ์
Subject: Principles for the Valuation of Hedge Fund Portfolios

Dear Ms. Vulpes,

We appreciate the opportunity to comment on the TC SC5's work on the Principles for the Valuation of Hedge Fund Portfolios. As a member of the Emerging Markets Committee, the following subject areas would be of our particular interest.

1. **Requirement of a third party for pricing distressed instruments**

   Involvement of the third party may reduce the problem of mispricing. However, it would induce higher cost on fund investors particularly in the case of smaller pools of investment. Besides, there an issue of timeliness and frequency of disclosure to investors to be further considered.

2. **Conflict of interest in case of illiquid investment valuation**

   In considering independence of a pricing agent, the parties taken into account should not be only the fund managers and the management companies but also the issuers of such illiquid instruments. There might be a chance that the agent's relationship with the issuer could lead to a distortion in pricing in favor of the issuers.

We do hope that our comments would be taken into consideration of the TC SC5. Should there be any further questions on the matter, please do not hesitate to contact us.

Best Regards,
Passanan

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STATE STREET.

VIA E-MAIL

June 21, 2007

Ms. Pamela Vulpes
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Spain

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Re: Comments on Principles for the Valuation of Hedge Fund Portfolios

Dear Ms. Vulpes:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Consultation Report entitled "Principles for the Valuation of Hedge Fund Portfolios" issued by the Technical Committee of the International Organization of Securities Commissions ("IOSCO") in March 2007. Headquartered in Boston, Massachusetts, U.S.A., State Street specializes in providing institutional investors with investment servicing, investment management, and investment research and trading services. With $12.3 trillion in assets under custody and $1.8 trillion in assets under management as of March 31, 2007, State Street operates in 26 countries and more than 100 markets worldwide.

As a leading service provider to the alternative investment industry, State Street is keenly aware of the increasing importance of hedge funds to global capital markets, as well as the concerns that surround the valuation of financial instruments employed by or held in hedge fund portfolios. State Street therefore welcomes the development of principles designed to assist responsible parties in the valuation of hedge fund portfolios so as to minimize the potential for valuation-related conflicts of interest and facilitate appropriate pricing. In this regard, State Street agrees that the development and implementation of written policies and procedures is an essential component of an effective valuation program. State Street also agrees that appropriate levels of independence should be brought to bear in the development, implementation and ongoing review of such policies and procedures, and that a hedge fund Valuation Committee or similar oversight body is best suited to fill this role. Finally, and notwithstanding the foregoing, State Street believes that there are circumstances where third-party service providers, such as administrators, can help to facilitate the hedge fund valuation process.

State Street's views on the proposed principles are based on, among other things, consideration of the following points:

a. Hedge funds play an increasingly important role in financial markets as a source of both innovation and liquidity. As a result, any attempt to regulate hedge funds should strive to balance the need for investor protection with the substantial market benefits that hedge funds provide.

b. Given their complexity, general lack of transparency and often illiquid nature, hedge funds are most suitable as investments for sophisticated high net worth or institutional investors (*e.g.,* corporations, endowments, pension plans, etc.).

c. Sophisticated institutional investors are presumed to understand their responsibilities to underlying beneficiaries/investors and have the means required to evaluate, review and monitor investments in complex investment vehicles such as hedge funds. Such investors are also presumed to have in place the expertise, systems and processes required to monitor and manage the risks associated with such investments, including valuation-related risks.

d. Notwithstanding the use of certain derivatives, synthetics or other financial instruments for which reliable market values are not readily available, the majority of financial instruments held in hedge fund portfolios continue to be of a type for which market values are readily available.

e. For the sub-set of underlying financial instruments for which market prices are not readily available, relevant valuations, by necessity, are driven by sophisticated, complex (and often proprietary) models developed by the Manager. As a result, there are limits to the extent to which independent valuations can be undertaken by third-party entities.

f. Hedge fund administrators possess the expertise and systems required to calculate and/or validate net asset values ("NAV") of hedge fund portfolios using predetermined formulae and/or inputs as directed and/or as provided, as applicable, by the hedge fund's Manager and/or Governing Body. As a general matter, hedge fund administrators do not typically exercise discretion with respect to the valuation of underlying financial instruments.

g. Notwithstanding the foregoing, there are a number of important functions that third-party service providers, such as administrators, can provide to facilitate the appropriate valuation of a hedge fund's assets, and therefore reduce potential conflicts of interest. These include comparing calculated NAV's against predetermined tolerance bands and maintaining historical valuation data to assist the Governing Body / Valuation Committee with its valuation-related responsibilities.

State Street's specific comments on each of the nine principles are set forth below. To facilitate your review, each principle has been restated in bold italics.

<u>Principle 1</u>: Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund.

State Street supports the establishment and implementation by hedge funds of policies and procedures relating to the valuation of underlying financial instruments, especially insofar as such policies and procedures relate to the valuation of financial instruments for which values are not otherwise readily ascertainable in the market. The establishment of such policies and procedures not only memorializes relevant pricing formulae and methodologies, but also facilitates consistent pricing among similar financial instruments held within a portfolio, thus reducing the likelihood of potential valuation-related conflicts of interest.

<u>Principle 2</u>: The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund.

State Street agrees that any policies and procedures relating to the valuation of financial instruments held or employed by the hedge fund should, among other things, identify the methodologies that will be used for valuation purposes. The identification of such methodologies facilitates the consistent valuation of similar financial instruments within a hedge fund portfolio. Moreover, to the extent required price inputs are available, the inclusion of relevant methodologies facilitates the independent calculation of the hedge fund's NAV by a third party (such as an administrator), as well as the ongoing review of relevant underlying financial instrument valuations by a hedge fund Valuation Committee or similar body.

<u>Principle 3</u>: The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.

While acknowledging that there may be cases when overrides are necessary and appropriate (*e.g.*, if there is some material change to the economics of an underlying investment), State Street believes that the consistent application of valuation principles and methodologies to economically similar financial instruments held or employed within a hedge fund portfolio is a key component of an appropriate valuation process.

<u>Principle 4</u>: The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.

State Street agrees that the periodic review of valuation policies by the Governing Body / Valuation Committee of a hedge fund is important to ensure their continued appropriateness, especially in cases where the hedge fund has changed its investment strategy or where underlying economic or market conditions have shifted. In this regard, to the extent that they have access to and maintain historical information relating to the pricing of economically similar underlying investments, third-party service providers may be able to assist the Governing Body / Valuation Committee with its review by noting if existing pricing methodologies have resulted in prices that substantially deviate from the norm for similar financial instruments.

***Principle 5*: The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed.**

State Street agrees that meaningful levels of independence should be brought to bear in the hedge fund valuation process, and that the best means for achieving this independence is through the organization of a hedge fund Valuation Committee or similar body. Hedge fund Valuation Committees – or similar bodies – are best suited for achieving "independence" in the valuation of underlying financial instruments because they can be comprised of persons who possess both independence from those making investment decisions and the required expertise necessary for meaningful oversight of the methodologies, formulae and inputs utilized in the valuation process -- expertise which may not be within the purview of third-party service providers, such as hedge fund administrators.

***Principle 6*: The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and in particular of any valuation that is influenced by the Manager.**

State Street agrees that appropriate levels of independent review should be undertaken to ensure that, to the extent possible, individual valuations are not inappropriately influenced by the Manager. As previously noted, State Street is of the view that a hedge fund Valuation Committee, or a similar body, is best suited to undertake this role. Additionally, objectivity and independence could be enhanced by, among other things, the creation of an industry-sponsored data pricing warehouse and/or broader dissemination of pricing inputs derived from third parties (such as counterparties).

***Principle 7*: A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party.**

State Street agrees that any valuation-related override should undergo a rigorous, independent review. As noted above, State Street is of the view that a hedge fund Valuation Committee, or a similar body, which possesses both independence from the investment management function and the required level of expertise, is best suited to undertake such a review.

<u>Principle 8</u>: The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.

As a hedge fund administrator, State Street agrees that it is important for Managers and/or Governing Bodies, as applicable, to conduct initial and periodic due diligence on third-parties that are appointed to perform services for the hedge fund. Such due diligence could include both the provision by the potential service provider of a Statement on Auditing Standards 70 Report ("SAS 70 Report") (or its equivalent), which relates to the scope and effectiveness of the service provider's internal controls, as well as a careful assessment by the Manager and/or Governing Body, as applicable, of the services to be provided. In this regard, it should be noted that notwithstanding the existence of appropriate valuation policies and procedures, a third-party service provider, such as an administrator, may be unable to "independently" calculate the NAV of a hedge fund portfolio if such calculations are dependent on inputs received from the Manager or other non market-based sources (*e.g.,* counterparty brokers). For this reason, among others, the establishment of a Valuation Committee, or similar body, is a key component of the NAV calculation process.

<u>Principle 9</u>: The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.

State Street agrees that transparency is a key component of vibrant and efficient financial markets. In this regard, hedge fund private placement memoranda and similar documentation, as well as ongoing investor due diligence reviews, provides some level of transparency with respect to the hedge fund valuation process. However, given (i) the lack of readily available market prices for a material portion of a hedge fund's underlying financial instruments (*e.g.,* derivatives, credit swaps, etc.), and (ii) the fact that methodologies developed to value such financial instruments are complex and often proprietary, it is unlikely that all arrangements and methodologies relating to the valuation of a hedge fund's underlying financial instruments will ever be made fully available to the investing public.

* * * * *

Once again, State Street appreciates the opportunity to comment on IOSCO's proposed Principles for the Valuation of Hedge Fund Portfolios. We would be happy to discuss with you any comments or questions you may have with respect to this submission.

Very truly yours,

Stefan M. Gavell,
EVP & Head of Regulatory
and Industry Affairs

Gary E. Enos,
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Ms Pamela Vulpes
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21 June 2007

Consultation report – Principles for the valuation of hedge fund portfolios

Dear Ms Vulpes,

On behalf of UBS, we would like to thank you for the opportunity to respond to the IOSCO consultation report *Principles for the valuation of hedge fund portfolios*. We welcome IOSCO's efforts to formulate common standards of regulation among its members to help promote just, efficient and sound financial markets.

UBS has multi-dimensional relationships with hedge funds (as manager, investor, administrator, counterparty, creditor etc) and is responding to the consultation report from a UBS Group perspective.

UBS is supportive of IOSCO's proposed principles and we believe that they will help promote a more consistent application of meaningful valuation policies and procedures, as well as independence in and transparency of the valuation process of hedge funds. Moreover, these principles are broadly in line with the valuation principles proposed by the Alternative Investment Management Association (AIMA), which were published in March 2007.

General comments

In general from the point of view of an independent administrator/calculation agent, the valuation policies and procedures recommended by IOSCO would be beneficial. However, hedge funds themselves may find them overly restrictive. This is because hedge funds do not typically have detailed documented procedures that they share with all stakeholders, but typically include broad principles that they adhere to in their Offering Memoranda. This gives them greater freedom to operate.

We also feel that the following areas were not fully addressed in the IOSCO paper:

- IOSCO should encourage hedge funds to provide audited performance and/or track records as well as to be more transparent in their use of investment strategies, leverage and hedging activities. This kind of information is particularly important when assessing lending values of hedge fund collateral.

- IOSCO could comment specifically on the fact that hedge fund net asset values (NAVs) can be distorted by incentive fee schemes and for IOSCO to opine on which schemes they felt were appropriate.
- Also, although beyond the scope of valuation, more could be done to encourage the shortening of lock-up periods to improve hedge fund liquidity.

Specific comments on IOSCO's principles

Below are some specific comments on the nine IOSCO principles:

- On the use of models – a model requires significant lead time for an independent administrator to identify, test and approve. This lead time may not be practical/forthcoming from the manager, preventing achievement of the standards under these principles.
- The AIMA principles cover investor disclosure more than the IOSCO principles, for example, there should be full disclosure each month of the percentage of the NAV that could not be independently valued.
- We wish to point out that, based on Cayman Fund Services internal standards as an administrator, recommendation 5(b) permitting valuations to be provided by independent reporting lines within the manager, would not be acceptable. Cayman Fund Services have set standards to obtain all prices independently of the investment manager. However, this is not an industry wide standard and most other administrators would accept varying levels of investment manager pricing. In fact, Cayman Fund Services has a higher standard in this area than other administrators, who may accept valuations provided in this way. Hence, recommendation 5(b) usefully serves as a floor – but not a ceiling – for this valuation procedure.

Final comments

UBS considers IOSCO's proposal an excellent general guidance; however, our own existing internal rules and valuation principles already go much further and regulators should continue to recognise that firms may wish to impose more stringent standards, as does UBS.

Nevertheless, the overall position of the IOSCO paper of encouraging independence in valuation processes without insisting on it reflects a sensible willingness by regulators to leave the industry to decide for itself where the cost/benefit balance should be when it comes to valuations.

Thank you again for the opportunity to respond and feel free to contact us if you have any questions.

Yours sincerely,

UBS AG

Richard Royston Executive Director Group Hedge Fund Risk Controller	Steve Hottiger Managing Director Group Regulatory Management

RESPONSE TO "PRINCIPLES FOR THE VALUATION OF HEDGE FUND PORTFOLIOS" (TECHNICAL COMMITTEE OF THE IOSCO, MARCH 2007)

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This response does not follow the list of questions set out in the consultation document.

1 Reliable valuations lie at the heart of the credibility of the hedge fund industry. The IOSCO's work in coordinating an international response to problems associated with the valuation of hedge fund assets is therefore to be welcomed.

2 Although the IOSCO's principles are not binding on members, they nevertheless offer the genuine prospect that in time they will come to represent recognised standards around which industry practice can 'crystallize'. The Financial Services Authority has already endorsed the principles; other regulatory and trade bodies will no doubt follow suit. Furthermore, the introduction of these principles is likely to be of interest to hedge fund investors, many of whom are high net-worth individual investors, as well as sophisticated institutional investors. Arguably, these investors have the ability to influence the behaviour of the hedge fund industry, and thus demand compliance with the IOSCO's principles. **Accordingly, despite the traditional reticence of the global hedge fund industry to bow to regulatory pressure, the prospect of the IOSCO's principles becoming the global industry benchmark seems very high indeed.**

3 **However, the extent to which endorsement by the regulatory authorities and adoption of the principles by industry bodies (and in turn hedge funds themselves) will successfully resolve problems associated with hedge fund valuations is more doubtful.** Two key, self-imposed, limits serve seriously to compromise the effectiveness of the IOSCO's valuation project. To begin with, the IOSCO's principles only deal with the valuation of the hedge fund's portfolio of financial instruments and, somewhat surprisingly, not with events that take place later in the process, such as the timeliness and methods by which net asset value (NAV) is communicated to investors. In addition, SC5's work has side-stepped the difficult issue of debating appropriate audit or accounting standards that should be applied to hedge funds and their assets, or to resolving differences in international approaches. While the latter omission, though still a weakness, may, for pragmatic reasons, seem understandable, the former limitation seems needless. The timeliness of valuations (and the means by which NAV is communicated to investors) as much as the accuracy of valuations, represents a key aspect of

the valuation process. What is more, it is an essential plank for the type of investor due diligence which the IOSCO sees as underpinning hedge fund policies and procedures. **Consequently, future IOSCO work should remedy this deficiency and address the timeliness and communication of valuations to investors.**

4 **However, a more fundamentally problems relates to the way in which the IOSCO principles deal with the 'independence issue' when valuing hard-to-value instruments.** According to SC5, independence is to be achieved primarily, but not solely, by way of scrutiny by independent parties, such as administrators or other independent third parties, so as to ensure that the practices are in keeping with the fund's formal documented policies and procedures. However, as the IOSCO's working party recognises, in relation to complex and/or illiquid securities, independent valuation may strictly speaking be impossible to achieve. In certain circumstances assets managers may be in the best position to value 'hard to value' financial instruments, or at least be in the best position to supply the information needed for other parties to value such instruments. As a result, independent parties will struggle to challenge these valuations/data upon which valuations are based. Moreover, investors—even those who are typically regarded as sophisticated—will find it difficult to impose any effective constraint on managerial decision-making in this respect.

5 **Such problems are, of course, especially acute where management receive performance fees while holding hard to value assets in a 'side pocket'.** Interestingly, and importantly, hedge fund managers are today increasingly marketing side pockets as an integral part of fund strategy, and allocating up to as much as 30% of capital to investment in illiquid instruments. One explanation for this development is that investing in illiquid instruments provides managers with opportunities to grow the fund and thus meet performance targets.

6 **However, the increasing significance of side pockets in the hedge fund sector, and the general lack of transparency regarding their use, also raises the spectre of abuse.** In particular, there is a significant risk that in the absence of proper safeguards managers may seek to hide poorly-performing assets in side pocket accounts and then write them off during a market down turn. The incentive to do so arises not only from the desire to discourage investors from pulling their remaining capital out of a seemingly ailing fund, but also from a desire to manipulate the value of their performance fees which may (wholly or partly) be calculated on the liquid proportion of the fund. Moreover, to the extent that performance fees can be collected on valuations of the illiquid portion of the fund held in the side pocket, further problems arise. Although constitutional and other offering documents typically stipulate that performance fees are not to be paid on the unrealized appreciation of illiquid side pocket investments, in practice, funds are increasingly providing for performance fees to be charged during the life of a side pocket. **In view of the manager's discretion in valuing—or providing information to help value—side pocket investments, a clear conflict of interest exists. Such a conflict has the potential seriously to erode the alignment of managerial**

interests with those of the fund's other investors. The IOSCO's work too readily glosses over this problem.

7 **The IOSCO's principles should place greater emphasis on the need for special policies and procedures which, at the very least, are alert to such practices.** One possibility is for the IOSCO's principles to stipulate that ordinarily best practice requires performance fees on 'hard to value' assets to be calculated only *after* the relevant instruments have been liquidated, and that any departure from this approach, if it is indeed to be permitted, should be explained to investors in a timely manner. Such a proposal implies the need for a clear distinction to be drawn within the fund between, on the one hand, liquid assets (or assets which objectively are deemed sufficiently liquid) for which valuations are relatively uncontroversial; and, on the other hand, hard to value instruments, in relation to which a more stringent regime is required. With regard to the former, the policy should be for performance fees to be calculated quarterly (as is typically the case) on the basis of NAV. However, with regard to the latter, performance fees on illiquid assets, for which there is no easily calculable NAV, should only be paid *after* the financial instruments are in fact liquidated. **The effect of such a principle would result in a much improved alignment of managerial interests with those of the fund's other investors—something which has been a traditional feature, not to say, major strength, of the hedge fund industry.**

8 One further ancillary issue is also relevant: who is responsible for valuation error? The IOSCO is encouraged to address this matter.

9 In summary: Important, though the IOSCO's attempt at introducing a set of global standards may be, the Organisation's principles are, for the reasons outlined above, ultimately flawed. Indeed, as they stand they risk masking inherent and potentially intractable problems in valuing assets which are at times highly illiquid and for which there may be no actively traded screen price. **This is especially so with regard to managerial discretion over the use of side pockets.** For all the timeliness and clear merits of much of the IOSCO's work in relation to hedge fund valuations, the Organisation's failure to get fully to grips with this issue represents a missed opportunity. Sooner or later, it will need to be revisited.