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## Plenary 3

### Hedge Funds – New Regulatory Challenges

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# GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION (2007)

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[www.aima.org](http://www.aima.org)



## GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

### What were the drivers of this research?

- AIMA wished to update its ground-breaking study on this topic released in 2005.
- Understanding of the issue, generally, has increased though in-depth knowledge is still lacking. AIMA seeks to bring further clarity to interested stakeholders.
- The hedge fund industry has progressed considerably in the areas of governance and transparency.

## GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

### Guide Objectives

- To enhance the existing Recommendations on
  - Governance,
  - Transparency,
  - Procedures, Processes & Systems, and
  - Sources, Models & Methodology
- To offer practical guidance on how these Recommendations apply to the hedge fund industry


## GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

### Key Facts

- Hedge fund industry has grown substantially since 2005
- Assets under management have increased to around \$1.4trn
- AIMA estimates that less than 23% of all hedge fund assets are hard-to-value and/or illiquid
- Substantial and increased interest in hedge funds among institutional investors and retail, in some countries
- Heightened attention from regulatory authorities and governments

## GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

AIMA believes that hedge fund managers are no different from managers of any other enterprises, in that they seek to run a successful business that delivers the best possible service and returns to clients. The vast majority of hedge fund managers appreciate that a key feature of the services they offer to investors is to conduct their own involvement in the valuation process with diligence and integrity.



# 15 RECOMMENDATIONS

*summarised*

1. Valuation policy document approved by Fund's governing body
  - a. defines the role of each party
  - b. defines the price sources
  - c. lays out the escalation and resolution procedure
2. Segregation of duties in the valuation process
  - a. no conflicts of interest
  - b. ultimate responsibility lies with the Fund's governing body
3. Transparency of process
  - a. identification of the party responsible for valuation
  - b. disclosure of any involvement by the Manager in the process
  - c. NAV reports communicated direct to investors
4. Segregation of parties to the valuation process, and to the investment process
  - a. where the Manager is necessarily involved, pricing must be supported
  - b. policies must be practically implementable
  - c. any deviations approved in advance by the Fund's governing body
5. Prices must be derived from multiple sources
  - a. broker quotations must be accessed directly by the valuing body
  - b. pricing models must be tested independently of the Manager
  - c. side-pocketing must be decided by the Fund's governing body

### Recommendations on Governance

- In advance of the Fund's launch a summary of practical and workable valuation practices, procedures and controls should be enshrined in a **Valuation Policy Document** and approved by the Fund's Governing Body, after consultation with relevant stakeholders. The Valuation Policy Document should be reviewed on a regular basis by the Governing Body.
- The Valuation Policy Document should explicitly clarify the **role of each party** in the valuation process, should identify **price sources** for each instrument type and should include a **practical escalation or resolution procedure** for the management of exceptions.



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### Recommendations on Governance

- The Governing Body of the Fund should ensure **adequate segregation of duties in the NAV determination process**, which may be achieved by **delegating** the calculation, determination and production of the NAV to a suitably **independent**, competent and experienced **Valuation Service Provider**. If the Investment Manager is responsible for determining the NAV, and/or acts as the Fund's Governing Body, **robust controls over conflicts of interest** should be established.
- **Oversight of the entire valuation process** and, in particular, resolution of pricing issues associated with hard-to-price illiquid positions and exotic instruments **remains the ultimate responsibility of the Fund's Governing Body**.

### Recommendations on Transparency

- The Fund's Offering Document should **explicitly name the party** to whom responsibility for the calculation, determination and production of NAV has been delegated.
- There should be adequate **disclosure of any material involvement by the Investment Manager** in the pricing of underlying portfolio positions.
- **NAV reports should be addressed directly to investors** by the Administrator, where an Administrator is used, and any NAVs produced by the Investment Manager should be qualified as such.

### Recommendations on Procedures, Processes and Systems

- The procedures enshrined in the Fund's Valuation Policy Document should be designed to ensure that **the parties controlling the Fund's valuation process are segregated from the parties involved in the Fund's investment process.**
- The industry recognises that **in certain instances the Investment Manager has the best insight** with respect to the valuation of particular instruments. Wherever prices are provided or sourced by the Investment Manager, the Valuation Service Provider should be furnished with sufficient supporting information by the Investment Manager.

### Recommendations on Procedures, Processes and Systems

- Procedures described in the Valuation Policy Document of the Fund **must be capable of practical implementation** by the Valuation Service Provider.
- The Valuation Service Provider should use reasonable endeavours to apply any pricing policy consistently. **Deviations** from the policy **should be approved by the Governing Body in advance** of any NAV being released.

### Recommendations on Sources, Models and Methodology

- Wherever possible the valuation of each position in the Fund's portfolio should be checked against a **primary and secondary price source**. The Valuation Policy Document should outline the hierarchy of sources to be used for each security type and the tolerance levels for variances between the sources.
- If the Governing Body approves the use of broker quotations for the valuation of certain instruments, these quotations should wherever possible be **multiple, sourced consistently** and accessed by the Valuation Service Provider independently **without intervention by the Investment Manager**.

### Recommendations on Sources, Models and Methodology

- Any decision to use a pricing model should be approved by the Governing Body and should be properly **justified** by appropriate testing. If an Investment Manager's pricing models are used they should be **independently tested and verified**.
- Any decision to allow the side-pocketing of illiquid/hard-to-value positions should be taken only after careful consideration by a Fund's Governing Body. If the Governing Body approves such a decision it should ensure that **side-pocket policies are clearly communicated to all investors**. The criteria for side-pocketing individual positions should be as consistent as possible.

## GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

### Next steps

- Inclusion of these recommendations in other AIMA Guides to Sound Practices
- Continue to monitor issues and developments
- Revisit the topic periodically

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