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Hedge Funds – New Regulatory Challenges

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Good afternoon Ladies and Gentlemen and thank you to both IOSCO and SEBI for inviting me to present here today. My name is Dan Waters and as chair of the IOSCO Hedge Fund Valuation Sub Committee, I have been asked to speak about the paper "Principles for the valuation for hedge fund portfolios", which IOSCO published last month and which is currently open for public comment. I would encourage all who feel they can make a material contribution to any aspect of the nine Principles, to submit their comments online to IOSCO during the consultation period, which closes on June 21.

Background

Let me first offer a bit of background to IOSCO's work on the Nine Principles. It is worth stating, first of all, the obvious point that valuation issues are by no means limited to hedge funds. The particular valuation challenges that arise from financial instruments that are illiquid or complex are shared by all investment funds, institutions and strategies that deal in such assets. The Alternative Investment Management Association (AIMA), in a recent survey, found that 23% of assets under management in hedge funds were in "hard to value" strategies. Of course, a hedge fund may operate a single strategy which is 100% exposed to assets in the "hard to value" category. For these and other reasons set out in the report, IOSCO thought it sensible to focus its valuation work on hedge funds and those who provide services and prices in respect of them.

Note too, that hedge fund failures that have caused investor losses have fortunately been quite rare, affecting on average less than 1/3 of 1 percent of all hedge funds per year. It is far more common that a hedge fund ceases trading and returns the capital to its investors because the fund has not attracted sufficient capital or the investment return has been below average. That said, where operational failures have contributed to dramatic declines in hedge fund values, many of these operational failures included weaknesses around the valuation process. Moreover, the average loss given default, where operational weaknesses were present, has been in excess of 50% of investors' capital. Investor losses in these circumstances were either entirely avoidable, or would have been detected far earlier, had controls around the valuation process been in line with good industry standards. We suggest that investors in funds that are not compliant with the IOSCO Principles are accepting greater risk than they probably realise.

In addition to focusing on hedge funds, we also tried to keep a very firm grip on the scope of our valuations work. The topic of valuations is potentially a very broad one. The IOSCO Principles cover the valuation process up until the point at which all the financial instruments in the hedge fund portfolio are valued. The Principles do not address events that take place later in the process, such as the timeliness and method by which the Net Asset Vale is communicated to investors. As important as these and other related issues are, they were beyond the mandate for this paper. Nor have we strayed into the difficult territory of debating appropriate audit or accounting standards that should be applied to hedge funds and their assets, or to resolving differences in international approaches. This paper most certainly would not have been completed in a year had we tried!

The working methodology here also broke new ground for IOSCO, as Martin has mentioned. IOSCO projects of this nature typically involve a working group composed only of regulators, who produce a report or study that is then subject to external consultation and comment. In this case, it seemed to me that the complexity of the issues and the desire to produce a set of standards in a reasonably quick timeframe argued for a different approach. Given the variety of counterparties and business structures utilized by hedge funds, and the complexity of the issues involved, it seemed essential to engage with experts who had first hand, detailed knowledge and practical experience of the problems involved.

The expert members were a diverse bunch, including senior people from hedge fund managers, prime brokers, auditors, accountants, administrators, valuation agents and fund of fund managers. This permitted some significant challenge amongst the different industry participants. One observation I can share with you is that working intensively with industry experts does not reduce the amount of debate. You do, however, get an interesting and productive one! Our experts worked diligently and continuously over the course of the past year, side-by-side with the regulators in the sub committee. IOSCO is very grateful for the time and effort expended by them. They offered us real insight into the desirable and practicable controls that should be placed around the hedge fund valuation process.

The last point to make by way of background is the target audience for the Nine Principles. First and foremost are the hedge funds themselves and those who manage their assets. In practice, the relationship between the funds and their managers is often very close, and the Principles recognise and seek to address this reality. We also are addressing, however, the institutional clients of hedge funds, be they pension funds, funds of hedge funds, other institutional investors or sophisticated, high net-worth investors. We consider that these kinds of investors have the capacity and the competence to influence the behaviour of the hedge fund industry by demanding high standards of independence, transparency and consistency. Indeed, in many instances they are already doing that. These Principles are intended to strengthen and facilitate the development of increasingly high standards in valuation policies and practices across the global hedge fund industry.

Summary of Nine Principles

Let me turn now to the Principles themselves.

The first thing to say is that IOSCO considers that the Principles represent a flexible but robust framework, which should promote good governance over the valuation process. When formulating the

Principles, IOSCO recognized that hedge funds and their managers operated a variety of business structures. In each of these structures, however, there is the potential for conflicts of interest between the interests of the hedge fund manager and the interests of the fund and its investors. The characteristics of the various jurisdictions in which hedge funds operate required careful consideration when formulating Principles for an industry that often cries, "One size does not fit all!" The aim has been to formulate Principles that should benefit investors across the full range of different structures.

Briefly summarised, the Nine Principles call for:

- Comprehensive, documented valuation policies and pricing procedures;
- Identification of the valuation methodologies used for all financial instruments;
- Consistent application of the valuation policies;
- Periodic review of the valuation policies and pricing procedures;
- Independent application of the valuation policies;
- Independent review of the resulting valuations, in particular of any valuation influenced by the Manager;
- A process for handling price overrides;

- Initial and periodic due diligence on third party valuation service providers; and
- The valuation arrangements to be transparent to investors.

You might say that these are a statement of the blindingly obvious. If that is your response, I encourage you to read the report closely. Each principle is elaborated through a number of additional pieces of guidance and illustrative examples. These reflect the complexity of the issues involved. In addition, in addressing practical problems, more than one Principle may come into play, which adds to the impact that they have in real-world scenarios.

You might expect that I would now move on to discuss each of the Principles in detail. I am not going to do that. They are already in the public domain, and time does not permit me to parse each of them individually. In the limited time available today, I think it might be more interesting to focus on what is not in the Principles and why. This will provide colour on the discussions we had while writing the Principles and insight into why we came out where we did. In the time available, I will touch upon one of the hotly debated issues associated with valuations and what IOSCO could and could not do about it.

Debate over independent pricing

The prime example of the debate of what should, or should not be, in the Principles arose when we considered the central issue of independence in the valuation process. Our Principles do not state that hedge funds must appoint an independent administrator. This has surprised some commentators. In explaining why we have come out where we have, I hope to illustrate the regulatory philosophy that informed our discussions, the reality of the complexity of the hedge fund investment world, and interplay between the nine principles in addressing real-world situations.

In respect of independence in the valuation process, IOSCO Principle 5 states:

> *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.*

The paper provides specific direction on ways in which to introduce appropriate independence. These include:

(i) third-party pricing services;

(ii) independent reporting lines within the Manager; and/or

(iii) a valuation committee.

Let's look at the first of these: retaining third-party pricing services. This will demonstrate that these Principles do not operate on the basis of "One Principle per issue ". Valuation issues are often too diverse and inter-related for there to be one simple solution for each issue. It is the collective use of several Principles that often creates effective controls around the valuation process.

The majority of hedge funds being launched today do contract with an external administrator to undertake third-party pricing. Why then did we not decide to go with the apparent flow and recommend this as the preferred option? There are three reasons, each of which is worth considering in a bit of detail.

1. Firstly, in some jurisdictions, traditional fund management companies have launched hedge funds and utilized their in-house resources to value the hedge fund portfolio, in much the same way they price their unit trusts. For hedge funds running the most common strategy, long/short equity, where the equities in the portfolio are liquid

and exchange listed, in-house pricing will not be a challenge, nor offer significant scope for manager influence. The AIMA survey found that all equity strategies were "easy-to-value" and were the most common hedge fund strategy. It hardly seems sensible to mandate an independent administrator for such strategies.

2. Secondly, administration firms (notwithstanding ongoing consolidation in this sector) offer varying levels of service and expertise in the valuations process. A move to retaining an administrator would not necessarily deliver a superior outcome for investors, as that is dependent on the administrator chosen by the fund and the services offered. Cost may be an important driver of that choice. Those funds that select the lowest-cost administrator may be also be accepting a commensurately lower standard and range of pricing service. Due to the range of financial instruments in which hedge funds invest, an administrator may, if they have insufficient pricing capability for some financial instruments, collaborate with a specialist valuation agent to obtain the appropriate expertise or consensus pricing. But this will increase the cost of the service and present a different choice to the fund. Many administrators, moreover, who endeavour to value more complex assets, observe the difficulty in retaining talented staff, and face competition with investment banks for staff with relevant experience.

Even where an independent administrator is chosen by a fund, that is not the end of the matter. IOSCO expects that the Governing Body should formally review the capability of external valuation service providers. Under Principle 8, we expect that:

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

This review is intended, as our report explains, "*to determine that the service provider has and maintains appropriate systems and controls and a sufficient complement of personnel with an appropriate level of knowledge, experience and training commensurate with the hedge fund's valuation needs*."

The bottom line is that simply finding an independent administrator is not a complete solution to the challenge of valuation of difficult assets.

3. The third reason independent administrators were not mandated is that hedge fund investors, the vast majority of whom are institutions and high-net worth individuals, have not universally demanded it. It seemed to IOSCO disproportionate to suggest that a particular business model

should be mandated, when the principal investors in hedge funds, who are well placed to make such demands, have not thought it necessary to do so.

That said, we do consider that investors should have access to all relevant information in order to make a proper evaluation of the valuation process being offered by a hedge fund or their appointed third party pricing providers.

Principle 9 states:

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

This includes:

- *A description of the roles, skills and experience of all of the parties that are involved in the valuation of the financial instruments of the hedge fund; and*
- *Information about the nature and degree of any contracted pricing services.*

This information will be required when an investor is considering their initial investment and during ongoing due diligence. Investors need to get comfortable, for example, with the role and ability of an independent third party pricing provider, rather than simply blindly relying on the fact of structural separation from the fund manager.

So our Principles do not require appointment of an independent administrator to value the hedge fund's portfolio assets. Instead, we note the availability of other methods, including separation of the reporting lines with the hedge fund manager and creation of a valuation committee that would include members of the management team who are not associated with the direct management of the portfolio. When the hedge fund does not use an independent pricing provider, there are a variety of other controls, such as the application of Principles 8 (continuous due diligence) and 9 (transparency of valuation processes), that should be used to mitigate the influence of the hedge fund manager over valuations.

In all of the three examples of independence offered under Principle 5, the fundamental importance of investor due diligence emerges. It is worth noting that the due diligence process, as practiced to the standard deployed by sophisticated institutional investors, is a very significant undertaking. For example, in testimony last month before the House Committee on Financial Services, a major U.S. university endowment fund explained that it spent 400 person hours in its initial due diligence process before investing in a fund and 70 hours per year, per fund, performing ongoing due diligence. While this may be near one end of the due diligence spectrum, our experience at the FSA suggests that many institutional investors and funds of hedge funds are very diligent indeed in their examination of the valuation policies and procedures of the hedge funds in which they invest.

Will the Principles Make a Difference?

Announcing a set of Hedge Fund Valuation Principles is all very well, but one might wonder whether they will actually make a difference in the real world. Whether they will or not is of course dependent in the first place upon whether or not they are taken up. IOSCO considers that this statement of principles represents good practice in the industry and that many hedge funds and their managers all already adhering to practices that are consistent with them. We consider that wider application of them should make a difference in helping to prevent future problems in the valuation of hedge funds.

I thought it might be instructive to consider how they might have operated in a real-world case. The SEC settled civil enforcement action against four partners from Beacon Hill Asset Management in 2004. In their complaint before the District Court, the SEC made the following allegations:

- that a fraudulent scheme had resulted in investors losing more than 300 million dollars;
- that material misrepresentations were made concerning:
    - the valuation methodology used for calculating the Net Asset Value;
    - the hedging and trading strategy for its funds that were said to be market neutral; and
    - the value and performance of these hedge funds.

There was an independent administrator involved in this case. One can only estimate the level of utility that the Principles may have delivered, but here are some hypothetical red flags that, if raised, might have been beneficial:

Red Flag 1. The administrator was alleged to have used prices sourced from the manager.

Principle 9 requires transparency to investors of the arrangements in place for the valuation of the portfolio, including "a description of the extent to which valuations have been provided by or influenced by the Manager" and "the roles…of all parties that are involved in the valuation of the financial instruments." These disclosures would have revealed that all prices were under the control of the manager, casting a different light on the apparent independence of the administrator.

Red Flag 2. There was an insufficient degree of independence in the valuation process.

Principle 8 outlines approaches that will increase the independence in hedge fund valuations. One option is creating a valuation committee. It was alleged that Beacon Hill's valuation policy required the use of prices from market makers and that its use of an internal model was a deviation from that policy. Under IOSCO Principle 7, the reasons for and contemporaneous documentation of evidence to support an override of the valuation policy would be required by the valuation committee. Those reasons and the evidence would have been subject to review by the committee.

Red Flag 3. An employee allegedly warned the CFO that portfolio duration and hedging reports raised serious doubts about the valuations and hedging strategies. It was alleged that the CFO took no action.

Instead of bringing concerns to the attention of an individual, bringing them to a valuation committee might have been a more effective forum for escalating potential problems.

No system is foolproof of course and the purpose of this example is not to suggest that the Principles represent a failsafe solution. Rather, it is to illustrate that failure to raise industry standards around the valuation process risks repeating costly mistakes of the past.

Conclusion and Next Steps

In conclusion, it would be naïve to expect that the application of the Principles will come about solely through the insistence of IOSCO alone. As I have mentioned, the hedge funds themselves and their managers, and, importantly, their investors all have a role to play. So we encourage active engagement with the Principles through this period of consultation. It is very important that they attract a high degree of international acceptance and active support, so it is essential that we get them right. We will be very pleased to receive and consider comments and critiques from those who have an interest in strengthening and improving valuation standards in the global hedge fund industry. Thank you for your kind attention.