

**Dermot S L Butler** of Custom House reflects on the perennial problems of pricing hedge fund assets

# Valuing integrity

**T**wo years ago, the Alternative Investment Managers Association (AIMA) published its research paper on 'Asset Pricing in the Hedge Fund Industry'. This was a unique document that took almost two years to put together and, whilst it covered most aspects of the valuation of assets in hedge funds, it did, of course, address in particular, the problems with valuing complex OTC and derivative instruments, as well as other illiquid instruments.

In March, AIMA produced a new 'Guide To Sound Practices For Hedge Fund Valuations' (AIMA's Guide), which, like the first paper, has been very well received by everyone in the hedge fund industry. However, this second paper is, as it suggests, a 'guide', rather than purely a 'research paper'. Both of these documents were produced partially because of the perceived increase in risk to the financial system, particularly in the hedge fund area, related to the potential of mispricing hard to value assets, such as complex OTC instruments.

## Risks and recommendations

In my opinion, the real risk with some of these more complex instruments is the possibility – some would say, probability – of the risk of systematic failure that could occur because some of the counterparties to the hedge funds do not have the necessary skills or systems to quantify the risk within their own books – but that is a topic for another day and another article. There is no doubt that there are huge risks inherent in mispricing hard to value assets. Those who are old enough to remember Askins Capital and Orange County, will recall that both funds blew up as a result of forced liquidations following a disagreement on the pricing of the underlying assets between the funds' manager and their prime broker/counterparty. In the process, many other indirect participants, including investors, were hurt and lawsuits flew.\*

Be that as it may, it is a fact that in today's market, there is great concern, not only by investors and managers, but also by service providers and

regulators, with regard to the integrity of prices used in the valuation of hedge funds. AIMA's Guide, which is an incredibly comprehensive document, consists of an overview of valuation issues, backed up by 15 recommendations in four areas, including: Governance; Transparency; Procedures; Processes, Systems and Sources; Models and Methodologies. It also has several appendices, which include Accounting Guidelines for Fair Value and a draft or template Valuation Policy Document for hedge funds.

In essence, the recommendations stated, with regard to governance, that:

- i. All hedge funds should have a Valuation Policy Document approved by the 'Governing Body' (the board of directors for a fund company). This Policy Document should be produced in consultation with other parties involved in the fund, including, obviously, the investment manager, administrator, prime broker and auditor.
- ii. Ensuring that conflicts of interest in the valuation process are properly managed and usually the most satisfactory solution is achieved by appointing an independent and competent 'Valuation Service Provider' – in other words, an administrator.
- iii. Thirdly, under Governance, it is clarifying the fact that the investment manager is responsible for the valuation and/or Governance and the robust controls over conflicts of interest that have to be established. These may have to be implemented by the administrator, but the investment manager, together with the board, are the parties that have to ensure that they are established. With regard to transparency, it is clear that investors should have the right to disclosure of any material involvement by the investment manager in the production of the fund's formal NAV. In my opinion, this should also be clarified within the offering document, so that investors have the opportunity to 'vote with their feet'.



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### Emphasising independent administration

Under the Procedures, Processes and Systems, the main points are that the parties controlling the valuation of the fund's assets and the process used for that valuation, should be different, or properly segregated, from the parties involved in the fund's investment processes. This, of course, is a problem for many US limited partnerships, where the general partner is both responsible for the administration and valuation of the limited partnership and responsible for the management of the assets. Obviously, this particular problem can be resolved by the appointment of an independent administrator. The second recommendation under this heading is that the procedures should be designed so that they can be implemented in a practical fashion and be consistently applied by the administrator.

### Reliable sources

The final recommendations come under the broad heading of Sources, Models and Methodology. The first of these is that multiple independent price sources should be used to verify the positions in a fund's portfolio.

Secondly, when you see broker quotations and pricing models for formal valuation purposes, these should be sufficiently tested and controlled – and this, of course, applies particularly with regard to brokers who may be the counterparty to the hedge fund with regard to a particular investment instrument.

The final recommendation concerns 'side pockets' in the context of illiquid or hard to value positions and recommends that such a decision should only be taken after very careful consideration by the board of directors (governing body). Their responsibility would then be to ensure that the policy relating to side pockets is properly communicated to the investors and to anyone else involved and consistently applied.

### Protection through policy

As I said, the above are summaries of the main recommendations, which are laid out in much greater detail within the document – which is available from AIMA for a very small consideration if you are a member, or at a slightly higher price if you are not! If you wish to obtain a copy, please contact Emma Mugridge at AIMA – [emma@aima.org](mailto:emma@aima.org).

One of the points, however, that is worth elaborating on is the requirement that each fund has written a valuation policy that is agreed by the governing body/board of directors – in consultation with other interested parties, including the investment manager, the administrator, custodian



or prime broker and auditor. Again, the valuation policy document outline included in the AIMA Guide goes into some detail as a template although it is, in my opinion, that not all funds would need to meet all of the policies outlined.

Nevertheless, it is a good and practical template and one that investment managers and administrators should follow, if only for their own protection in this increasingly litigious world. Why do I say that? I say it because I know that AIMA's Guide has been received enthusiastically by some regulators and, in fact, I know of one extremely well regarded regulator who has told a hedge fund administrator that they believed that all hedge funds, that this firm acts for, should have a detailed written valuation policy. This document should specify not only how the current portfolio should be valued, but also anticipate the policy if the investment strategy changes in the future. If the policy document is properly drawn up, then it might defuse potential litigation.

*\* These are my personal opinions, not reflected specifically in the AIMA Guide.*