HEDGE FUND ASSET VALUATIONS AND THE WORK OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

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Abstract This article seeks to explore and subsequently critique the International Organisation of Securities Commissions's (IOSCO) attempt to devise a globally recognized set of benchmarks of good practice in valuing hedge fund assets as set out in its recent Principles For the Valuation of Hedge Fund Assets (A Consultation Report, March 2007). The outcome of the IOSCO's consultation process is almost certain to have an important bearing on the future provision of hedge fund valuation services globally and, thus, is likely to be viewed with great interest by regulatory and industry bodies throughout the world.

I. INTRODUCTION

Estimates indicate that globally the hedge fund industry manages assets in excess of $1.5 trillion, split between over 9,000 hedge funds.[1] Although the bulk of these highly controversial investment vehicles are located offshore in tax havens such as the Cayman Islands, the British Virgin Islands and Bermuda, hedge fund managers—ie those who manage and advise funds on investment policy—tend to be based onshore. By far the most popular location for managers is the US, where almost 70 per cent of global hedge fund assets are under management.[2] Yet despite the US's domination of the hedge fund sector, European growth has also been spectacular, accounting for almost one quarter of assets under management.[3] Significantly, nearly 80 per cent of all European hedge fund assets are managed by London-based advisers,[4] making the UK the second largest player in a sector that is attracting sustained scrutiny.[5]

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[1] International Financial Services, London, 'Hedge Funds, City Business Series' (Apr 2007) <http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2007.pdf> 1. However, in view of the fact that hedge funds routinely employ leverage (ie borrow against their assets) their impact on the financial markets is greater than the assets they have under management. ibid.

[2] ibid.

[3] ibid.

[4] S Gray, 'London tightens grip as European hedge funds boom' Hedgeweek Special Report (Dec 2006) <http://www.hedgeweek.com> 3–6.

[5] London is also Europe's leading centre for prime brokerage, with over 90 per cent of European business: Report of the Alternative Investment Expert Group: Managing, Servicing and

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One issue which has attracted attention from industry bodies,[6] regulatory authorities[7] and investors,[8] revolves around the valuation of hedge fund assets. In contrast to the strict regulatory requirements which apply to retail investment vehicles, such as unit trusts and other regulated collective investment schemes,[9] hedge funds are not under an obligation to have their assets independently valued. What is more, often hedge funds have positions in illiquid and/or complex assets, for which there is no 'public screen price'.[10] In such circumstances, those who perform valuations are ordinarily reliant upon counterparty quotes and/or direct valuations by the hedge fund manager. Since the level of fees that fund managers receive is based on the value of the fund's portfolio holdings, there is a very real incentive for the hedge fund manager to overstate valuations, and thus claim performance fees on profits that do not in fact exist.[11] Compromised valuations are, in turn, likely to disrupt 'the quality

Marketing Hedge Funds in Europe (July 2006) <http://ec.europa.eu/internal_market/securities/docs/ucits/reports/hedgefunds_en.pdf> 14. Prime brokers (often investment banks) execute hedge fund trades, grant lines of credit to funds and hold hedge fund assets on 'margin' account.

[6] See, for example, the Alternative Investment Management Association (AIMA), Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry (Apr 2005, updated Mar 2007), and the Managed Funds Association (MFA) Sound Practices for Hedge Fund Managers (November 2007).

[7] In the UK, see, for example, Financial Services Authority (FSA), Hedge Funds: A Discussion of Risk and Regulatory Engagement (Discussion Paper 05/4) (June 2005) <http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf>. See also, D Waters, 'Hedge Funds—New Regulatory Challenges' (Speech on behalf of the FSA 12 Apr 2007) ('[To the extent that] operational failures have contributed to dramatic declines in hedge fund values, many of these operational failures [include] weaknesses [associated with] the valuation process.') <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0412_dw.shtml> 1. In the US, see, for example, Securities and Exchange Commission (SEC) Staff Report, Implications of the Growth of Hedge Funds (Sept 2003) <http://www.sec.gov/news/studies/hedgefunds0903.pdf> (hereinafter SEC, Staff Report) and Testimony of Randall K Quarles, before the Senate Banking, Housing, and Urban Affairs Subcommittee on Securities and Investments of (16 May 2006). At the international level, see, for example, the International Organization of Securities Commission's (IOSCO) work, which is the subject of this article.

[8] According to a recently published report by State Street, almost two-thirds (64 per cent) of institutional investors claim that accurately valuing their hedge fund holdings is problematic: 'Hedge Fund Valuations "Problematic" Say Investors' (Apr 2007) International Custody and Fund Administration <http://icfamagazine.com/?id=me/37/news/105/44056/0/>.

[9] At the European Union level, retail collective investment schemes are regulated under the Undertakings for Collective Investments in Transferable Securities Directive (UCITS), Directive 85/611/EEC, as amended, inter alia, by Directive 2001/107/EC (the 'Management Company Directive') and Directive 2001/108/EC (the 'Product Directive'). The latter two Directives are generally known as UCITS III.

[10] It is estimated by the Alternative Investment Management Association (AIMA) that today 23 cent of hedge fund strategies are in hard to value securities (eg distressed debt, emerging markets, fixed income arbitrage): Waters (n 7) 1.

[11] FSA, Hedge Funds: A Discussion of Risk and Regulatory Engagement (Discussion Paper 05/04) 49 (hereinafter: FSA DP 05/04); and FSA, Hedge Funds: A Discussion of Risk and Regulatory Engagement (Feedback on DP05/4) (Mar 2006) 5 (hereinafter 'Feedback Statement 06/2'). To the extent that fund managers deliberately issue false valuations criminal sanctions could follow (eg Financial Services and Markets Act, 2000 (FSMA), s 397). In the US, see, eg SEC, Staff Report (n 7) fn 257. For a more recent example, see 'Hedge Fund Chief Accused of Overstating Assets by 2,500%' *The Times* (London, 8 Feb 2007).

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and fairness of the prices at which investors buy or redeem interests in some hedge funds'.[12] Moreover, they are also likely to adversely affect price formation in markets more generally and to impact on the 'margin' and other collateral requirements that prime brokers[13] demand in return for the investment capital they supply to hedge fund managers.

Significantly, the fluid nature of the hedge fund sector means that overly zealous regulation by domestic regulators could serve to drive many onshore hedge fund mangers (over whom domestic regulators are currently able to exercise jurisdiction)[14] to offshore centres, as funds engage in a process of 'regulatory arbitrage'. Such an approach thus risks triggering a 'race to the bottom', with relatively lax rules prevailing. In an attempt to counteract such problems, the International Organization of Securities Commissions (IOSCO)—the world's primary forum for international cooperation by securities regulators—is at the forefront of moves to address mounting problems associated with hedge fund valuations. In particular, the IOSCO's Technical Committee Standing Committee on Investment Management (SC5) has recently published a set of principles which it is hoped will attract global consensus, and in so doing come to represent a benchmark of good practice in valuing hedge fund assets.[15] Although currently only for public consultation, the credibility of these principles, and their likelihood of adoption, has been enhanced by fact that SC5 employed a new working methodology, entailing

[12] 'The absence of any form of independent oversight over hedge fund pricing raises significant questions about the quality and fairness of the prices at which investors buy or redeem interests in some hedge funds', SEC, Staff Report, ibid 79–80.

[13] Prime brokers are usually investment banks who provide capital and risk management services to hedge fund managers, execute hedge fund trades and so on.

[14] In the UK, for example, hedge fund managers do not as yet need a specific 'permission' under the Financial Services and Markets Act 2000, Part IV. Instead, hedge fund managers/advisers who are located in the UK—and who provide investment advice and make day-to-day investment decisions for offshore 'master funds'—will be authorized to do so as a consequence of their permission to manage or advise on investments generally: Arts 37 and 53 of the Regulated Activities Order (RAO), respectively. Firms providing such services will be required to meet the threshold conditions under FSMA, 2000, Schedule VI. Failure to maintain the threshold conditions enables the FSA to vary or cancel the permission: FSMA 2000, s 45. An authorized person will also be required to meet the FSA's requirements on 'Senior Management Arrangements, Systems and Controls' (ie 'take reasonable care to establish and maintain such systems and controls as are appropriate to its business' (SYSC 3.1.1R)). And, in relation to private and intermediate customers, to abide by the FSA's dealing and managing Conduct of Business rules such as best execution and fair and timely trade allocation. In addition, any individuals performing 'controlled functions' in accordance with s 59 will require approval by the FSA. Though similar, a more extensive regime will apply in the wake of the implementation of the Markets in Financial Instruments Directive 2004 (MIFID). Unlike under the Investment Services Directive (ISD), MIFID makes both investment advice and dealing in commodity derivatives a core activity for which a passport will be available.

[15] Technical Committee of the IOSCO, *Principles for the Valuation of Hedge Fund Portfolios* (Consultation Report, Mar 2007) 6 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>. IOSCO Technical Committee Standing Committee on the Regulation of Market Intermediaries (SC3) was also consulted. See also, Waters (n 7) 3. For a discussion of these principles, see text accompanying (n 96).

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representation not only from key global regulators (eg the Financial Services Authority (FSA)[16] and the Securities and Exchange Commission (SEC)),[17] but also from a broad spectrum of industry experts such as 'hedge fund managers, prime brokers, auditors, accountants, administrators, valuation agents and fund of fund managers'.[18] This article represents an attempt to engage with this debate and is intended, at least in part, as a contribution to the IOSCO's call for comments on its proposed new benchmark standards.

In addressing the above issues, the article proceeds as follows. Part II provides a short description of hedge funds and the investment techniques they typically employ. Part III explores the nature of the valuations problem, particularly with regard to the increasing use by some hedge funds of illiquid investments and concerns over the appropriate use of what are known as 'side pockets'.[19] The significance of ensuring that valuations are not overstated is particularly acute given the growing retailization of the hedge fund sector (through the more active involvement of pensions funds and other institutional investors)[20] and the consequent risk that retail investors could ultimately be affected by valuation problems. Part IV outlines and critically assesses the IOSCO SC5's work in seeking to devise a globally recognized set of principles capable of commanding international agreement from domestic regulators, market players, and investors alike. Finally, in Part V, I set out my conclusions. In essence, the argument I present is that despite the timeliness of the IOSCO's work in attempting to formulate robust new international guidelines, in certain respects they have only limited potential. Moreover, where performance fees are paid on the basis of illiquid assets held in 'side pockets' *before* they are liquidated, a more prescriptive approach is required.

II. HEDGE FUNDS: WHAT ARE THEY AND WHAT DO THEY DO?

Lacking legal definition in the UK or, indeed, at the international level, hedge funds are widely understood as representing a form of 'alternative' investment vehicle. In their 'purest' offshore form, hedge funds are private, pooled investment entities, largely unregulated and targeted in the main at wealthy

[16] The FSA regulates the UK's financial services industry (including banking, securities, derivatives and insurance). By virtue of FSMA 2000, s 2, the FSA has four main objectives: maintaining market confidence; promoting public understanding of the financial system; protecting consumers; and reducing financial crime.

[17] The SEC regulates the US securities markets.

[18] Waters (n 7) 1.

[19] These are special 'carveout' accounts used for the purposes of segregating illiquid investments from the fund's other investments. These side pocket accounts are then used for the purposes of helping to calculate redemption rates and performance fees.

[20] Nearly two-thirds of institutional investors allocate more than 5 per cent of their portfolios to hedge fund strategies. Only 4 per cent of institutional investors have no allocation at all: State Street survey. Reported in: 'Hedge Fund Valuations "Problematic" Say Investors' (Apr 2007) International Custody and Fund Administration <http://icfamagazine.com/?id=me/37/news/105/44056/0/>.

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investors. Their defining characteristic is essentially their relative flexibility in comparison to other pooled investment vehicles.[21] The exact legal form of offshore hedge funds (whether corporate, trust, or contractual) is mainly determined by the tax considerations of their onshore investors. In view of the largely unregulated nature of offshore funds, hedge fund managers are at liberty to invest in an unlimited range of investments (such as distressed debt, emerging markets, or fixed-income arbitrage) and may employ a variety of investment strategies, prominent amongst which are short selling[22] and the use of derivatives. What is more, funds typically utilize leverage opportunities (that is to say they borrow against funds under existing management), thus augmenting their investment potential and in turn amplifying, for good or ill, their impact on financial markets more generally.[23]

In contrast to retail collective investment vehicles, where managers seek to outperform a selected 'benchmark' (such as the FTSE 100), hedge fund managers pursue absolute returns. Thus, in a falling market, retail investment managers are considered successful even if they lose money, provided they beat their benchmark,[24] whereas in a rising market they are regarded as being unsuccessful even if they make a profit yet under-perform against the benchmark. Hedge fund managers, however, are considered successful only if they are profitable in both rising and falling markets. Compensation arrangements (typically a 2 per cent management fee and a 20 per cent performance fee) are structured so as to clearly align managers' incentives with the fund's investors in the hope of generating absolute returns regardless of market conditions.[25] In addition, most hedge funds require their managers to invest significantly in the fund, thus placing the manager's own capital at risk if the fund performs poorly.[26]

As well as offering an important source of portfolio diversification for institutional (and other sophisticated) investors, hedge funds are further said to be increasingly important providers of liquidity to the financial markets (by acting as willing buyers or sellers of financial instruments) and as helping to allocate capital and risk more efficiently.[27] In so doing, hedge funds are becoming increasingly recognized by both market players and regulators as

[21] (n 5) 10.

[22] In essence, short selling involves selling a financial asset that is not currently owned in the hope that it will fall in value.

[23] For a discussion of the systemic dangers that hedge funds pose for financial markets, see, J Danielsson, A Taylor, and J-P Zigrand, 'Highwaymen or Heroes: Should Hedge Funds be Regulated? A Survey' (2005) 1 Journal of Financial Stability 522, 528–33.

[24] SEC, Staff Report (n 7) 36.

[25] ibid. Often compensation arrangements involve the use of 'high water' marks and 'hurdle' rates. Essentially these are predetermined thresholds which managers must beat before performance fees are paid. ibid 62.

[26] FR Edwards and S Gaon, 'Hedge Funds: What Do We Know?' (2003) 15 Journal of Applied Corporate Finance 8, 17.

[27] See, Danielsson et al (n 23) 533–5.

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being a force for good in promoting the overall health and stability of global financial markets.

To a large extent, the term ‘hedge fund’—with its origins in the idea of ‘hedging one’s bets’—is a misnomer. Today, hedge funds focus ‘almost exclusively on the speculative role of investment management, that is, the attempt to outperform the market average by superior security valuation and successful trading strategies’.[28] Although it is virtually impossible to capture fully the flavour of the various strategies that hedge funds typical employ, three main strategies may nevertheless be identified.[29] These are: (a) market trends strategies; (b) event-driven strategies; and (c) arbitrage strategies.

A. Market Trends

Market-trend-driven (or, directional) strategies seek to generate returns by predicting major market trends and other significant market movements (often as a result of a change of government policy) which will have an impact upon equities, interests rates, or commodities.[30] Prominent among the investment entities employing such strategies are ‘global macro’ funds, where the term ‘global’ refers to the fact that the investment opportunities pursued may be on a worldwide scale, and where the term ‘macro’ is a reference to attempts by fund managers to utilize macro-economic principles in the hope of uncovering major price shifts in targeted asset classes.[31] Thus, for example, global macro funds typically make investment decisions based on various countries’ macro-economic fundamentals such as ‘interest rates, currency exchange rates, inflation, unemployment, industrial production, foreign trade, and political stability’.[32] As a result, where a ‘country’s economic policies look questionable and raise doubts about its ability to sustain its exchange rate, macro funds [are liable to] take positions designed to profit from devaluation, usually by selling the currency short’.[33] Perhaps the most famous global macro fund was George Soros’ Quantum Fund which, by selling pounds sterling short, forced the UK’s ignominious and costly withdrawal from the Exchange Rate Mechanism (ERM) in 1992.

[28] G Connor and M Woo, ‘An Introduction to Hedge Funds’ <http://www.lse.ac.uk/collections/accountingAndFinance/pdf/ConnorIntroToHedgeFundVv3.pdf> 26. ‘Funds of funds’ hedge funds, invest in other hedge funds. The main benefit of this strategy is portfolio diversification.

[29] Staff Report to the SEC (7) 34.

[30] ibid.

[31] JG Nicholas, ‘Introduction to Global Macro funds’ in S Drobny (ed), *Inside The House of Money* (John Wiley, New Jersey, 2006) 1.

[32] (n 28) 26.

[33] SEC, Staff Report (n 7) 34. Short selling, involves selling a financial asset that is not currently owned in the hope that it will fall in value.

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B. Event-Driven

'Event-driven' strategies, by contrast, seek to exploit investment opportunities associated with discrete events concerning corporate activity, such as corporate insolvencies, reorganizations, mergers, or takeovers. A fund may, for example, purchase the securities of a firm that is in serious financial trouble in the hope that the company may undergo a successful reorganization and prove profitable once again. Such 'distressed securities' often trade at a significant discount to their 'true' market value since banks and other institutional investors are subject to regulatory constraints which limit the types of investments they may hold. Alternatively, a fund may take a long position in a company that is thought to represent a potential takeover target (in the hope of eventually securing a premium from the potential bidder) while at the same time taking a short position in the bidding company (since the bidder's share price often falls in the event of a successful bid). In essence, with 'event-driven' strategies, hedge fund managers seek to benefit from the fact that the market has mispriced the securities of individual companies and that they can profit from their superior insights regarding future market developments. According to a new Credit Suisse/Tremont Hedge Funds Index study, event-driven strategies produced returns of 15.62 per cent in the previous 12 months, representing the top-performing hedge fund strategy in the study.[34]

C. Arbitrage Strategies

Arbitrage strategies meanwhile seek to identify and exploit pricing disparities between securities that are closely related, while at the same time attempting to insulate themselves from the effects of adverse market-wide movements.[35] The use here of the term 'arbitrage' varies somewhat from its traditional usage, since hedge fund arbitrage strategies are associated with trades that 'entail some risk of loss or uncertainty about total profits'.[36] Although their low volatility makes such strategies attractive, they nevertheless require 'medium to high leverage in order to benefit from small pricing distortions, particularly in fixed income markets'.[37] This involves, for example, exploiting short-term anomalies in various bonds (such as Treasury Bills and corporate bonds).

III. HEDGE FUND VALUATIONS—THE NATURE OF THE PROBLEM

Despite widespread recognition of the benefits that hedge funds offer global financial markets, there is also growing awareness amongst industry bodies,

[34] 'Event Driven Tops Hedge Fund Strategies, says Credit Suisse' (1 June 2007) <http://www.investorsoffshore.com/asp/story/storyinv.asp?storyname=27469>.

[35] SEC, Staff Report (n 7) 35.

[36] ECB Occasional Paper No 34 (Aug 2005) 9.

[37] ibid.

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investors and regulators that hedge funds pose serious threats. One issue which has attracted increasing attention revolves around the means by which the financial instruments hedge funds invest in are to be valued. Valuations are central to the operation of the hedge fund industry, since the net asset value (NAV) of each fund's portfolio of financial instruments represents the means by which subscriptions and redemptions are calculated.[38] To the extent that the fund's assets are liquid, and traded on a recognized investment exchange (such as the London Stock Exchange) or some other liquid market for which prices are readily available, valuations will be relatively uncontroversial. However, where complex and/or illiquid financial instruments represent a not insignificant proportion of the fund's assets, acute problems are likely to arise. These problems stem from the fact that such instruments are infrequently traded and are thus inherently more difficult to value.

Furthermore, difficulties associated with highly complex, illiquid assets are compounded by the conflict of interest which exists between the hedge fund manager and the fund's other investors. Because illiquid instruments do not have a 'public screen price', managers are more likely to be involved in helping to facilitate valuations by, for example, providing information and price quotes.[39] Accordingly, there is a risk that management's decisions in this respect will be polluted by the fact that the valuation of certain instruments within the fund's portfolio will influence the level of performance fees managers receive.[40] The use of leverage—with its capacity to amplify potential losses—heightens further a manager's incentive to inflate valuations unjustifiably.[41] As the FSA's Chairman, Callum McCarthy, claims hedge fund valuations revolve around issues of both competence (who validates the models? Where are the objective data for volatility?) and integrity (has there been collusion between parties supplying data and those who stand to benefit from the valuations derived from that data?).[42] Overvalued assets are, in turn, likely to adversely impact on investors and to hamper price formation more generally. Indeed, in view of the mounting evidence that institutional investors, such as pensions funds, are committing a higher proportion of their

[38] C Kundro and S Feffer, 'Valuation Issues and Operational Risk in Hedge Funds' [2004] Journal of Financial Transformation 41, 42. See also, Deloitte's Financial Services Group, 'Precautions that Pay Off—Risk Management and Valuation Practices in the Global Hedge Fund Industry' (3 May 2007) 8 <http://www.mondaq.com/article.asp?articleid=48142> (hereinafter 'Deloitte Research Survey'). Gross Asset Value (GAV) meanwhile excludes the calculation deduction of any performance fees or other liabilities.

[39] 'Deloitte Research Survey' ibid 7.

[40] FSA, DP 05/04 (n 11) 49; and FSA, Feedback Statement 06/2 (n 11) 5.

[41] Leverage can also exacerbate the impact of valuation errors on counterparties and in turn the financial markets generally.

[42] C McCarthy, 'Hedge Funds: What Should be the Regulatory Response?' (Speech on behalf of the FSA 7 Dec 2006) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1207cm.shtml>.

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assets to hedge funds,[43] there is a real risk that retail investors could also be adversely affected.[44]

As is well recognized by regulators around the globe, the last decade has seen an explosion of interest in complex and illiquid financial instruments.[45] Such instruments offer the prospect of higher returns, albeit that they are associated with increased risk. According to the Alternative Investment Management Association (AIMA), 23 per cent of hedge fund strategies are in 'hard-to-value' securities (such as distressed debt, emerging markets, convertible bonds, credit default swaps and fixed-income arbitrage).[46] Moreover, this figure looks set to increase in the foreseeable future as hedge funds seek to sustain their claimed superior returns in comparison to more traditional forms of pooled investment vehicle, such as unit trusts and regulated open-ended investment companies (OIECs). Significantly, however, in a recent AIMA global survey, almost one-third of asset managers who responded identified the pricing of illiquid assets/instruments as representing the 'most significant challenge' regarding portfolio valuations.[47]

Despite the fact that, unlike retail collective investment vehicles, hedge funds are under no legal obligation to have their assets independently valued,

[43] Nearly two-thirds of institutional investors allocate more than 5 per cent of their portfolios to hedge fund strategies. Only 4 per cent of institutional investors have no allocation at all: State Street survey. Reported in: 'Hedge Fund Valuations "Problematic" Say Investors' (Apr 2007) International Custody and Fund Administration <http://icfamagazine.com/?id=me/37/news/105/44056/0/>.

[44] As the FSA recognizes, incorrect valuations are also likely to have implications for 'margin' requirements (ie the assets hedge funds must deposit with prime brokers in order to secure loans from brokers); 'capital' requirements (ie certain minimum levels of capital which must be maintained as a means of absorbing losses); and 'reporting' requirements (obligations which require financial entities, inter alia, to report certain trades to the regulatory authorities). For example, calculating margin levels will depend significantly on the value of the financial instruments under management by the fund. In so far as valuations are overstated, margin levels may be inaccurately calculated, thus exposing prime brokers to an increased risk of hedge fund default.

[45] FSA, 'Financial Risk Outlook 2006' 5 <http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2006.pdf>.

[46] See Waters (n 7) 1 (though 'an investor in a fund which focuses on just one of these strategies may have a 100% exposure to hard-to-value assets'). Spearheading this movement are private equity firms. Evidence indicates that the line between private equity/venture capitalists and hedge funds is becoming increasingly blurred, as hedge funds seek new opportunities from which to generate fees: D Townley, 'Hedge Funds 2006: The Changing Regulatory Landscape—The Convergence of Hedge Funds and Private Equity Funds' (Sept 2006) Practising Law Institute Corporate Law and Practice Course Handbook Series PLI Order No 8467, 217. See also, JE Tabak, 'Private Equity/Hedge Fund Convergence, Hybrid Funds' (10/11 July 2006) Practising Law Institute Corporate Law and Practice Course Handbook Series PLI Order No 8449, 297 ('In an attempt to generate higher returns . . . [m]ore hedge funds are participating in private equity-type investments through side pockets or designated investments (hybrid funds).' 302).

[47] Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry <http://www.pwc.com/extweb/pwcpublications.nsf/docid/76A9FB7EC537CA7485257000003124CD/$File/aima.pdf> (hereinafter: 'AIMA Global Survey'). '[To the extent that] 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.' Waters, ibid.

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it has nevertheless become 'standard industry' practice (at least in Europe) for net asset value (NAV) assessments to be carried out by independent administrators or other independent third parties.[48] According to a recent Deloitte Research Study of the hedge fund industry, 61 per cent of respondents use administrators to calculate their official NAV, while another 17 per cent use other third parties.[49] However, even here such valuations are not necessarily genuinely 'independent', since there is widespread recognition that administrators often lack the necessary technical expertise to value highly complex and/or illiquid assets properly[50] and are inclined to 'defer' to the valuations provided by onshore hedge fund advisers to calculate NAV.[51] One of the explanations offered for this lack of expertise is that compensation levels within the administration/valuation sector of the hedge fund industry are not sufficiently high to enable administrators et al to attract and subsequently retain the quality of personnel needed to perform complex valuations accurately.[52] Thus, although the number of third-party entities seeking to provide valuation services has increased over the last decade, as the Deloitte Research Study concludes, 'in the short to medium term, there remain doubts as to the reliability of the services provided by these participants'.[53]

Aside from the risk of error due to lack of expertise by administrators and/or other inexperienced third-party valuers, problems are also likely to occur where complex instruments are 'marked to model' (ie where mathematical models are used to calculate value) rather than 'marked to market' (ie where the prevailing market price for an instrument determines its value). By definition, models rest on assumptions and thus may provide forecasts that are highly subjective and which, in turn, are open to question.[54] What is more, there is also the risk of what is known as autocorrelation.[55] Typically, a financial instrument is valued on the basis of a chosen methodology which is

[48] According to figures cited in a report commissioned by the European Commission, as of June 2005, Ireland domiciled administrators serviced in excess of 3000 hedge funds totalling assets of almost $0.5 trillion: (n 5) 14.

[49] (n 38) 8.

[50] (n 45) 5. See also (n 5) 31: 'it is true that third-party vendors are increasingly trying to offer competent valuations in respect of complex assets; however, in the short to medium term, there remain doubts as to the reliability of the services provided by these participants.'

[51] SEC Staff Report (n 7) 56; FSA, DP 05/4 (n 11) para 3.90: 'In respect of assets for which there are no easy or robust valuation methodologies and counterparty quotes are unavailable, administrators usually accept the hedge fund manager's own valuation. This can sometimes mean that a significant proportion of the fund's assets are not subject to independent valuation. Hedge fund managers generally perform their own internal valuations of all positions and seek to reconcile these with the administrators at the end of the month. It would appear that the hedge fund managers may wield significant ability to influence the administrators' "independent" valuations at this point in the process through their dialogue with administrator staff and the counterparties who are providing the quotes.' See also, Deloitte Research Study (n 38): 'in many cases hedge fund advisers provide valuations to the administrators who then re-value the portfolio to assess the reasonableness of the valuations.' 8.

[52] Deloitte Research Study (n 38) 31.

[53] ibid.

[54] Kundro and Feffer (n 38) 42.

[55] R Ehrenberg, 'Information Arbitrage'. <http://www.informationarbitrage.com/2006/08/side_pockets_us.html>.

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applied on a regular basis over a given period of time. In the case of complex, illiquid assets which are difficult to value, and whose values will inevitably vary over time, the repeated use of the same methodology month after month, quarter after quarter, is likely to result in the volatility of returns associated with holding the asset to be understated.[56] This results in a tendency to distort fund returns and render problematic any attempt to make reliable comparisons between firms and strategies.[57]

To the extent that hedge funds—whether by virtue of their governing body or their fund manager—rely on exchange quotes as a means of valuing hard-to-value assets, additional problems arise.[58] Notwithstanding the fact that exchange quotes are appropriate for liquid, actively traded securities, the use of such sources for thinly traded assets is much more problematic.[59] In particular, the 'bid-ask spread' (ie the difference between the buying and selling prices offered by a party—classically a 'market maker'—for a security) is likely to vary substantially in view of the absence of an active market.[60] Indeed, according to Kundro and Feffer, broker quotes for some types of mortgage-backed securities are apt to vary by as much as 20–30 per cent.[61] Accordingly, prices quoted for thinly traded assets may be unreliable estimates of the prices received as a result of actual transactions.[62]

Further strain on the valuations process has surfaced in relation to the way in which illiquid instruments are managed within hedge funds. Increasingly, such assets are placed in what are known as 'side pockets', special 'carveout' accounts which serve to segregate hard-to-value assets from the fund's other investments and which may be used to help calculate redemption rates and performance payments.[63] The instruments transferred to a side pocket are 'identified with the ownership interests of the investors in the fund at the time the investment is made'.[64] However, in the event that an investor wishes to

[56] ibid.

[57] ibid.

[58] Surprisingly, evidence indicates that even for hard to value assets many hedge fund mangers rely heavily on exchange quotes. ibid 9.

[59] ibid.

[60] ibid.

[61] Kundro and Feffer (n 38) 42.

[62] Deloitte Research Study (n 38) 9. '[I]n the case of illiquid assets, it is virtually impossible to find a completely objective pricing source, forcing reliance upon models or observed or implied prices based upon the judgment of market participants, none of whom may be disinterested in the transaction.' D Waters, 'FSA Regulation and Hedge Funds: An Effective Proportionate Approach for a Dynamic, International Marketplace' (Speech delivered on behalf of the FSA, 19 Oct 2006) 4, <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1019_dw.shtml>.

[63] D Townley, Y Kawata, and L Landa, 'The Convergence of Hedge Funds and Private Equity' (June 2006) Practical Law Company (PLC) 2, <http://www.practicallaw.com/2-204-0965>. See also, 'A Word on the Side (Pockets)' [Aug 2006] Hedge Fund Review 12 <http://www.hedgefundreview.com>.

[64] PM Rosenblum, 'Private Investment Funds: Basic Structures And Current Developments' American Law Institute—American Bar Association Continuing Legal Education ALI-ABA Course of Study (26 Jan 2007) 71. Though occasionally managers create a 'separate class of fund interests with some investors only sharing in the liquid positions in the fund's portfolio, while others, with a longer-term appetite for commitment, participate in the side pocket portion of the

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redeem his share in the fund, the means by which any investment in the side pocket is dealt with varies. Some funds 'estimate the value of side pocket instruments and include a payment for them in the redemption price generally'.[65] By contrast, other funds 'exclude side pocket value from the redemption proceeds for investors wishing to redeem from the fund before the illiquid positions are sold', in which case the redeeming investor 'simply relinquishes any interest in the side pocket'.[66] More common, however, is where the fund permits an investor to 'redeem the liquid portion of their interests but retain his investment with respect to the investor's share of illiquid positions'.[67] The exact value of the side pocket, and thus the investor's share in it, is only determined when the illiquid assets are actually sold.[68]

Originally, such side pockets were deployed as a means of protecting investors from the risk of the redemption of certain assets from the fund.[69] In the absence of side pockets, managers would have more discretion to redeem liquid assets first, thus leaving a higher proportion of illiquid assets in the fund and, as a result, exposing the remaining investors to a higher level of risk associated with holding difficult-to-sell (and difficult-to-value) illiquid financial instruments.[70] Interestingly, and importantly, hedge fund managers are today increasingly marketing side pockets as an integral part of fund strategy,[71] and allocating up to as much as 30 per cent of capital to investment in illiquid instruments.[72] One explanation for this development is that investing in illiquid instruments provides managers with opportunities to grow the fund and thus meet performance targets.

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 downturn. 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.[73] 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 normally stipulate that performance fees are not to be paid on the 'unrealized appreciation [of] illiquid side

fund as well.' H Ordower, 'Demystifying Hedge Funds: A Design Primer' [2007] UC Davis Business Law Journal 323, 328.

[65] Ordower, ibid 328.

[66] ibid.

[67] ibid.

[68] Rosenblum (n 64) 71.

[69] SEC, Staff Report (n 7) 65, fn 224.

[70] Rosenblum (n 64) 71.

[71] ibid.

[72] I McMurdo, 'Offshore: Cayman Islands' (14 June 2005) <http://www.caymanfinances.com/news.cfm?view=51>.

[73] ibid.

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pocket investments',[74] this rule is by no means universal. Indeed, in practice, funds are 'increasingly providing for performance fees to be charged during a side pocket's life'.[75] In view of the manager's discretion in valuing—or providing information to help value—side-pocket investments, again 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 risk of abuse in the context of hedge fund valuations is, of course, not merely theoretical. In the UK, in March 2006, the FSA obtained an undertaking from Mr Jae Wook Oh, a hedge fund investment manager at Regents Park Management LLP ('Regents Park') that he would not undertake any 'controlled function'[76] for at least three years. The undertaking followed the discovery, by the FSA, of what appeared to be discrepancies between the realizable value of certain investments and valuations provided by Regents Park. Unsurprisingly, similar cases have also surfaced in the US.[77] For example, in SEC-sponsored administrative proceedings against JD Barry, TP Daniels, JM Irwin, and MP Miszkiewicz ('Beacon Hill Asset Management') the SEC claimed, inter alia, that the respondents 'made material misrepresentations to investors about the valuation methodology Beacon Hill used for calculating its NAVs',[78] and 'manipulated the valuations to allow steady and positive growth to be reported, and to hide losses'.[79] When Beacon Hill's prime broker challenged the valuation of the fund's assets, the defendants further claimed that the losses were substantially lower than in fact was true. The SEC subsequently agreed a range of sanctions with the defendants.

More generally, the SEC has 'a number of enforcement cases [pending] against hedge fund advisers involv[ing] the adviser's valuation of fund assets in order to hide losses or to artificially boost performance.'[80] Indeed, according

[74] See also, P Cockhill, 'A Word on the Side (Pockets)' [Aug 2006] Hedge Fund Review 12, <http://www.hedgefundreview.com>.

[75] ibid. That said, payments to the manager may be subject to a 'clawback arrangement' whereby mangers may be required to recalulate fees and compensate investors for any payments made as a resulted of over-inflated valuations which upon liquidation turn out to be incorrect. TA Hickey III and R O'Brien, 'Convergence: The Buzzword for Hedge Funds and Private Equity Funds in '06' <http://www.klgates.com/files/Publication/4f83eb54-fe33-4d57-9ebe-97a09955aa05/Presentation/PublicationAttachment/1666b427-19de-4c0b-a256-9c42077f5674/converge.pdf>.

[76] See, FSMA, 2000, s 59.

[77] For example, see *SEC v Peter W Chabot, Chabot Investments, Inc, Sirens Investments, Inc, Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No 18214 (3 July 2003); *SEC v David M Mobley, Sr*, Litigation Release No 18150 (20 May 2003); *SEC v Edward Thomas Jung*, Litigation Release No 17417 (15 Mar 2002); and *SEC v Jerry A. Womack*, Litigation Release No 17293 (2 Jan 2002). See also, 'Hedge Fund Chief Accused of Overstating Assets by 2,500%' *The Times* (London, 8 Feb 2007).

[78] *In the Matter of John D Barry, Thomas P Daniels, John M Irwin, and Mark P Miszkiewicz* (4 Nov 2004) <http://www.sec.gov/litigation/admin/ia-2320.htm>.

[79] ibid.

[80] Testimony of Susan Ferris Wyderko Director, Office of Investor Education and Assistance Before the Subcommittee on Securities and Investment of the US Senate Committee on Banking, Housing, and Urban Affairs (16 May 2006) <http://sec.gov/news/testimony/ts051606sfw.htm>.

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to one hedge fund study, valuation problems have played ‘a primary or contributing role in 35 percent of hedge fund failures [with] fraud as the underlying cause [accounting] for more than half of such failures.’[81]

Lately, a more aggressive stance by investors (especially in the light of greater institutional investor involvement in the hedge fund sector), coupled with greater self-awareness within the hedge fund industry itself, have combined to help generate improvements in the process by which valuations are conducted. Guidelines recently issued by, for example, the Alternative Investment Management Association (AIMA) and the Managed fund Association (MFA)—the two largest global trade associations—represent important steps in helping to promote these improvements. Nevertheless, despite such market-led initiatives, managers still retain a significant discretion over the means by which the valuation of complex and/or illiquid instruments is to be conducted. Indeed, according to a recent AIMA survey, as many as 22 per cent of their surveyed respondents calculate NAV in house; and in the context of complex and/or illiquid assets there is widespread recognition that hedge fund managers are themselves likely to be best placed to provide the ‘most reliable or indeed the only source of information’ about how such assets are to be valued.[82]

Managerial discretion in these matters also extends to the way in which valuations decisions are disclosed to investors, with a recent Deloitte Research Study reporting that over 30 per cent of surveyed respondents failed to disclose valuations to all investors on a routine basis.[83] Furthermore, review of the policies and procedures adopted by hedge funds was found to be variable, often with no definite time-frame set for review and little regular monitoring of valuation methods so as to facilitate any necessary revisions.[84] To these concerns may be added the above-mentioned problems about the way in which the performance of the fund can be manipulated through the increasing use of side pockets to secure enhanced performance.

IV. THE WORK OF THE IOSCO’S HEDGE FUND VALUATION COMMITTEE (SC5)

If nothing else then, IOSCO interest (through its Technical Committee Standing Committee on Investment Management (SC5)) in the problems associated with hedge fund valuations is certainly timely. Moreover, given the IOSCO’s standing within the international regulatory community, its work

‘Process, procedural or systems problems accounted for 30% of . . . valuations-related failures and mistakes or adjustments were implicated in . . . 13%.’ See also, Kundro and Feffer (n 38) 42.

[81] William H Donaldson (Chairman of the SEC) Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers Before the US Senate Committee on Banking, Housing, and Urban Affairs (15 July 2004).

[82] (n 15) 9.

[83] Deloitte Research Study (n 38) 8.

[84] ibid.

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provides a unique opportunity for regulators and industry experts to tackle valuation problems in a measured and proportionate fashion.

The IOSCO itself was formed in 1983, following the express desire of eleven securities regulatory agencies from North and South America to become part of an international cooperative body. The following year, securities regulators from France, Indonesia, Korea and the United Kingdom became the first members from outside the Americas to join. Within little over a decade, the IOSCO had established itself as the 'international standard setter' for securities markets around the world,[85] and had become recognized as the 'world's most important international cooperative forum for securities regulatory agencies'.[86] In 1998 the Organization adopted a comprehensive set of *Objectives and Principles of Securities Regulation* ('IOSCO Principles'), which today represent the international regulatory benchmarks for all securities markets.[87] More recently, in 2005, the Organization endorsed the IOSCO Memorandum of Understandng (MOU) as the 'benchmark for international cooperation among securities regulators'[88] and outlined 'strategic objectives to rapidly expand the network of IOSCO MOU signatories by 2010'.[89] Furthermore, the IOSCO approved as an unambiguous operational priority the effective implementation—in particular within its wide membership—of both its 'Principles' and its 'MOU', which are considered as primary instruments in the Organization's fight to facilitate cross-border cooperation, reduce global systemic risk, protect investors and ensure fair and efficient securities markets.[90] More generally, the IOSCO has adopted a 'comprehensive consultation policy designed to facilitate its continuous interaction with the international financial community and in particular with the industry'.[91]

In keeping with the IOSCO's role as an international standard-setter, on 7 February 2006 the IOSCO's Technical Committee approved a mandate proposed by the IOSCO's Technical Committee Standing Committee on Investment Management (SC5) to 'examine the policies and procedures employed by hedge funds in the valuation of their portfolios'.[92] Specifically,

[85] The Organization's wide membership regulates more than 90 per cent of the world's securities markets <http://www.iosco.org/about/index.cfm?section=history>.

[86] The IOSCO's members regulate more than one hundred jurisdictions and the Organization's membership is steadily growing.

[87] An updated version of the IOSCO's Objectives and Principles of Securities Regulation (May 2003) can be found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>. In 2002, IOSCO adopted a multilateral memorandum of understanding (IOSCO MOU) designed to facilitate cross-border enforcement and exchange of information among the international community of securities regulators. The following year, the Organization endorsed a comprehensive methodology (IOSCO Principles Assessment Methodology) that enables an objective assessment of the level of implementation of the IOSCO Principles in the jurisdictions of its members and the development of practical action plans to correct identified deficiencies.

[88] 'IOSCO Historical Background' <http://www.iosco.org/about/index.cfm?section=history>.

[89] ibid.

[90] ibid.

[91] ibid.

[92] (n 15) 6 (footnotes omitted).

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SC5's task was to design, in cooperation with industry representatives from both the European and US hedge fund sectors, a 'single, global set of principles relating to the valuation of the financial instruments employed or held by hedge funds when implementing their strategies'.[93] Emphasizing the cooperative nature of SC5's work, the IOSCO is quick to point out that the working party's efforts build upon the 'very substantial analytical and practical work that has been done in this area by industry associations, academics and market participants'.[94] The thrust of SC5's important initiative is aimed at the 'implementation of [a] comprehensive [set of] policies and procedures for [the] valuation of hedge fund portfolios'.[95] Its nine general principles in relation to hedge fund valuations—set out and discussed below—are designed to attract global consensus, and in so doing it is hoped that they will come to represent a benchmark of good practice in valuing hedge fund assets.[96] The relationship between a hedge fund's governing body and its investment manager is inevitably a close one, yet although the thrust of SC5's work has significance for both groups, ultimately it is the governing body's responsibility to ensure that appropriate policies and procedures are adopted and implemented.[97]

A. The IOSCO's Nine Principles

The IOSCO's nine proposed principles are as follows:

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

The principal means by which the IOSCO's SC5 has sought to address problems associated with the valuation of hedge fund assets is through the use by hedge funds of 'documented policies and procedures'.[98] These are to be designed with the aim of identifying clearly the 'obligations, roles and responsibilities of the various parties and personnel who are involved in the valuation process'.[99] Given differing hedge fund structures and operations, the IOSCO recognizes that these policies and procedures will inevitably need to be tailored to ensure that they are appropriate for different commercial contexts. To this extent, SC5 has eschewed a 'one-size-fits-all' approach.

[93] ibid.

[94] ibid 7.

[95] ibid 6.

[96] Waters (n 7) 1.

[97] (n 15) 10.

[98] ibid 13. The SC5 distinguishes between 'policies' and 'procedures'. According to SC5 'policies' refer to 'high level' valuation policies; while 'procedures' refer to 'the pricing procedures which outline the detailed processes by which prices are obtained for valuing the financial instruments of an investment portfolio': ibid 6 fn 2.

[99] ibid 13.

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When establishing these policies and procedures, funds are encouraged to address a non-exhaustive list of considerations, such as:[100]

- the competence and independence of parties responsible for valuing the fund's assets;
- the specific investment strategies of the hedge fund and the financial instruments held in the fund's portfolio of assets;
- the controls over the selection of valuation inputs, sources and methodologies by which fund investments are valued;
- the procedures by which differences in the valuation of instruments are to be reconciled;
- the procedures by which valuation adjustments are to be made; and
- the time-frame within which valuations are to take place.

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.*

In relation to Principle 2, emphasis is placed on the selection criteria adopted for pricing assets (eg the models and inputs used for valuation purposes) and the need to explain and justify the methodologies used in achieving accurate valuations.

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

Principle 3 addresses the issue of consistency in valuing hedge fund instruments. Here the principle of treating like instruments alike is seen as a key means of achieving fair valuations. Accordingly, as a rule of thumb, the IOSCO is of the view that valuation models for given instruments should remain consistent over time and that any departure from this principle should be clearly explained and justified.

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

In view of changing market dynamics, Principle 4 recognizes that fund policies and procedures should be subject to periodic review, thus ensuring that valuation methodologies are altered to suit changing circumstances. The onus in this respect is on the governing body of the fund in conjunction with the hedge fund manager to ensure that such review occurs. Moreover, where a hedge fund decides to invest in new instruments, valuation methodologies should be reviewed in advance.

[100] ibid.

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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.*

Principle 5 emphasizes the governing body's obligation to ensure that an appropriately high level of independence exists in relation to the way in which the valuations process is conducted. This may be achieved either by: (a) third party valuing services (eg administrators); or (b) the use of independent reporting lines within the fund management entity (eg ensuring that the people who supply valuations are different from those who take investment decisions); or (c) by virtue of a valuation committee which regularly reviews the valuation policies and procedures, strengthened if needs be by the appointment of independent persons ancillary to, but unconnected with, the hedge fund's managers. Thus, there is no outright obligation to appoint an independent administrator.

Furthermore, an appropriate level of independence is required both in relation to (a) the valuation of the assets and (b) review of the relevant policies and procedures.

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.*

The types of problems that Principle 6 is designed to address revolve around instances where prices/valuations are only available from a counterparty or a broker, or, more pertinently, from the fund manager himself. According to recent research undertaken by Deloitte, despite the fact that 80 per cent of respondents sought broker quotes to value their credit-swaps, as many as half of these relied *solely* on broker quotes. As the study recognized:

> [w]hile broker quotes are often necessary to value certain types of assets, using broker quotes alone poses some [problems]. [For example, is] the broker the counterparty to the transaction? Has the fund performed due diligence on the broker? Is the broker being used a market maker? Would the broker be ready to close the position at the quoted value? Does the firm solicit multiple broker quotes—as it should? Is a broker rotation followed, so the fund gets a variety of views? Finally, since broker quotes do not represent actual trades, are the broker's prices back-tested against actual transactions to check for reasonableness and systematic bias?[101]

SC5's solution to problems such as these is, again, the need for an appropriate level of independent scrutiny. For example, this might include:

- verification of prices by a comparison amongst counterparty-sourced pricings and over time;

[101] Deliotte Research Study (n 38) 10.

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- examination and documentation of any exceptions;
- validation of prices through comparison with realized prices against recent carrying values;
- consideration of the reputation, consistency and quality of the pricing source adopted;
- comparison with prices generated by a third party (eg comparison of prices generated by a fund manager versus those generated by a valuation agent);
- highlighting and researching any differences which appear unusual and/or which exceed the valuation threshold established for the type of financial instrument being valued; and
- review of inputs used in model-based pricing.

Where relevant, the criteria used to value an instrument should be notified to the independent valuer. In turn, the valuer should ‘ensure that all methodologies, including sources and/or inputs, or changes thereto, are selected with impartiality and on merit alone’.[102] The rationale for selecting any pricing source and/or input should be contemporaneously documented 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.*

Here the emphasis is on ensuring that any ‘price overrides’ (ie where the valuation of any given instrument is rejected by the fund manager) are compliant with the policies and procedures adopted by the fund. Details and any reasons for the override should be documented contemporaneously, and the override should be independently reviewed before it is used.

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

Principle 8 is directed at the credentials of any third parties entrusted with the task of conducting valuations. In essence, the hedge fund’s governing body is under a duty to conduct initial and periodic due diligence on any third party appointed to carry out valuations. In this respect, the IOSCO’s *Principles on Outsourcing of Financial Services for Market Intermediaries*, approved in February 2005, provides additional help regarding the types of due diligence measures that the governing body may wish to take.[103]

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

Rational decision-making requires transparency. This, in turn, requires access to reliable information as well as the presence of actors who are able to process that information and subsequently make reasoned judgments based upon

[102] (n 15) 18.

[103] <www.iosco.org/library/pubdocs/pdf/IOSCOPD187.pdf>.

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it. Accordingly, Principle 9 recognizes the need for a hedge fund's policies and procedures to be made freely available to investors on request. Implicit in this principle is the idea that, ultimately, it is the investors who are responsible for ensuring that the fund adheres to its policies and procedures throughout the valuations process.

B. *An Assessment of IOSCO's Principles*

Despite the fact that the IOSCO's proposed Principles do not bind members, there is nevertheless a real prospect that in time they will come to represent recognized standards around which regulatory and industry practice can 'crystallize'. Already the FSA has endorsed the Principles,[104] and they have also found favour with other organizations such as the AIMA[105] and the MFA.[106] Furthermore, work on a set of valuation 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 'capacity and the competence to influence the behaviour of the hedge fund industry, by demanding high standards of independence, transparency and consistency'.[107] Accordingly, despite the traditional reluctance of the global hedge fund industry to bow to outside/regulatory pressure, the likelihood of the IOSCO's proposed Principles becoming the global industry benchmark seems very high indeed.

[104] 'FSA supports IOSCO Principles for the valuation of Hedge Fund Portfolios' (14 Mar 2007) <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/034.shtml>. This is hardly surprising since acting Chair of SC5 was in fact FSA Director, Dan Waters.

[105] 'AIMA Welcomes IOSCO's Endorsement of its Valuation Principles' (27 June 2007) <http://www.hedgeweek.com/articles/detail.jsp?content_id=119838&livehome=true>.

[106] MFA comment letter to the IOSCO on its *Consultation Report on Principles for the Valuation of Hedge Fund Portfolios* (21 June 2007) <http://www.managedfunds.org/downloads/IOSCO%20Valuation%20Letter%20June%2021%202007.pdf>.

[107] Waters (n 7) 1. This may, however, overstate investors'—even sophisticated investors'—abilities to influence hedge funds. According to one US study: '[i]n practice, even very large and sophisticated investors often have little leverage in setting [the] terms of their investment and accessing information about hedge funds' SEC Staff Report (n 7) 47 and sources cited there. To the extent that this is also true of the UK, many hedge fund investors are offered 'membership' of the fund on what effectively amounts to a 'take-it-or-leave-it' basis, rather than as the result of any form of 'bargain' in the traditional sense of that term. See, *Schroder Music Publishing Co Ltd v Macaulay* [1974] 3 All ER 616 per Lord Diplock. Self-protection—at least in the classical sense—is at best severely restricted and, at worst, wholly illusory. Furthermore, since 'enforcement' of the IOSCO's proposed Principles is clearly a weakness, it has been suggested that the '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.' CFA Institute Centre for Financial Market Integrity, 'Re: Principles for the Valuation of Hedge Fund Portfolios' (21 June 2007) 5 <http://www.cfainstitute.org/centre/issues/comment/2007/pdf/valuation_of_hedge_fund_portfolios.pdf>.

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The Principles themselves plainly have considerable merit, representing as they do an important step by the international regulatory community in seeking to engage with an increasingly powerful hedge fund industry. Moreover, unlike prescriptive, detailed rules, the IOSCO's principles-based approach is sufficiently flexible to accommodate changing market circumstances, something that could be particularly important in the rapidly evolving hedge fund sector. Similarly, the principles are essentially 'outcome focused'. Accordingly, funds with different operational and structural needs have a discretion regarding how exactly the fund's policies and procedures are to be implemented. Finally, by eschewing a detailed rule-bound approach, greater scope exists for valuation issues to be incorporated into the fund's overall decision-making processes rather than representing an adjunct and consequently pointless exercise in box-ticking.[108]

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. The fact remains that the IOSCO's approach has a number of limitations (some self-imposed), which serve seriously to compromise the effectiveness of its valuation project. To begin with, certain important issues are ignored by SC5's work. For example, the Principles contained in the IOSCO's Consultation Report relate only to the valuation of a hedge fund's portfolio of financial instruments and, somewhat surprisingly, not to 'events that take place later in the process, such as the timeliness and methods by which [NAV] is communicated to investors'.[109] In addition, SC5 has side-stepped 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'.[110] 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 the hedge fund policies and procedures being proposed. Consequently, the IOSCO's ongoing work in this area should seek to remedy this deficiency and address specifically the timeliness and communication of valuations to investors.[111]

[108] For similar arguments in relation to the FSA's new principles based regulation, see, FSA, Principles-Based Regulation (Apr 2007).

[109] Waters (n 7) 1.

[110] ibid.

[111] SC5's work also ignores the valuation of instruments that have the effect of creating liabilities for the fund. Indeed, it has been suggested by the CFA that the Principles should be modified to call upon '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.': CFA (n 107).

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As regards the actual Principles themselves, certain issues are dealt with in a cursory and ultimately unsatisfactory manner. First, in relation to valuation methodologies (Principle 2), no indication is provided that one particular valuation method is viewed as superior to another. This should be remedied through a ranking of valuation methodologies, such as (a) public-exchange-based quotations, (b) generally accepted valuation methods, and (c) proprietary valuation models.[112] Likewise, in relation to the disclosure of any models used and inputs relied upon to generate valuations, Principle 2 simply does not go far enough. Fund policies and procedure should, in addition, disclose and explain both the nature of the investment instrument being valued and its underlying structure.[113] Such information forms the basis upon which investors and counterparties are able to assess 'appropriateness of valuations and the appropriateness of transacting with the fund'.[114]

More fundamentally, the way in which the IOSCO's working party deals with the 'independence issue' (Principles 5 and 6) when valuing hard-to-value instruments is open to criticism. As shown earlier,[115] funds have a discretion over how independence is to be achieved (eg by relying upon third-party valuers/administrators; separate reporting lines within the investment advisory arm of the fund manager; or, a valuation committee[116] consisting, possibly, of some members independent of the fund management arm). These parties are vested with the specific task of ensuring that the fund's practices are in keeping with its formal documented policies and procedures. Accordingly, SC5's proposed Principles do not, as one might initially expect, stipulate that funds *must* have their assets valued by an independent administrator.

A number of reasons have been offered to justify this approach.[117] First, in some jurisdictions (eg the US) traditional fund-management companies have established their own hedge funds and rely on already-established in-house valuation systems to conduct asset valuations. This is usually uncontroversial in relation to liquid or exchange-traded instruments. Thus, given that the most common hedge fund strategies are directed at instruments which are exchange-based, SC5 took the view that 'it did not seem necessary or appropriate to mandate an independent administrator for such strategies'.[118] Secondly, in view of the variable quality of third-party administrators a 'move to retaining an administrator would not necessarily deliver a superior outcome for investors'.[119] A final reason offered relates to the fact that investors have

[112] CFA (n 107).
[113] ibid.
[114] ibid.
[115] (n 100) and accompanying text.
[116] According to the CFA '[t]he IOSCO 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 valuations process?' London Buy Side Forum, 'Feedback on the Consultation Report "Principles for the Valuation of Hedge Fund Portfolios"' (18 June 2007) <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD250.pdf>.
[117] Waters (n 7) 2.
[118] ibid.
[119] ibid.

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shown no urgency in requesting that independent administrators should be used.

Yet whatever the merits of these justifications, independence of whichever type envisaged by the IOSCO's proposed Principles is likely to be difficult, if not impossible, to achieve—at least in relation to hard-to-value instruments. As argued earlier,[120] in such circumstances assets managers may in fact 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 such valuations. 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. Regrettably, the IOSCO SC5's Principles too readily gloss over these concerns.

Such problems are, of course, especially acute where management receives performance fees while holding 'hard-to-value' assets in a side pocket. The IOSCO's proposed 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 asset valuation. However, with regard to the latter, the payment of performance fees on illiquid assets, for which there is no easily calculable asset valuation, should only be made *after* the financial instruments are in fact liquidated.[121] 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.

V. CONCLUSION

The valuation of complex and/or illiquid assets is, of course, a problem that is not confined to the hedge fund sector. Nevertheless, the emergence of hedge funds as an increasingly important facet of global financial markets, and the growing retailization of the sector, has prompted regulators (both domestic and global) to take a more active interest in how these alternative investment

[120] (n 39) and accompanying text.

[121] Ehrenberg (n 55).

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vehicles are to be governed. Problems surrounding valuation of hedge fund assets head a long and growing list of other concerns. Despite investor pressure and regulatory controls, hedge fund managers nevertheless have a realm of discretion within which to manipulate aspects of the valuation process. Inaccurate valuations can adversely affect hedge fund counterparties (and their risk assessment of hedge fund borrowings) but can also leave investors exposed to risk. Indeed, estimates indicate that in 2005 valuation-related losses in hedge funds globally were in the region of $1.6 billion.[122]

As early as June 2005, at least one leading domestic regulator—the FSA—had taken the view that a 'global, voluntary cooperative exercise may have merit'.[123] According to the FSA, a precedent for such work could be found in the success of the IOSCO's *Code of Conduct Fundamentals for Credit Rating Agencies* (December 2004),[124] where the IOSCO demonstrated that it was capable of working with an industry that was unregulated in many jurisdictions so as to 'develop a number of criteria which the rating agencies have undertaken within their own codes of practice'.[125] The work of the IOSCO's SC5 has shown this confidence to be well founded, demonstrating yet again the Organization's growing ability to galvanize key players across the sector and produce high quality work which is both timely and practical.

Nevertheless, laudable and important though the IOSCO's recent attempt at devising a set of global standards may be, the Organization's proposed measures are ultimately flawed. Indeed, as they stand, they either ignore or gloss over important aspects of the valuations process. Particular problems arise with respect to managerial discretion over the valuation of 'hard-to-value' assets and the use of side pockets. Thus, for all the timeliness and clear merits of much of the IOSCO's work in relation to hedge fund valuations, SC5's failure to get fully to grips with this critical issue means that sooner or later it will need to be revisited. The IOSCO's public consultation period provides such an opportunity and this article offers a contribution to that debate.

[122] Waters (n 62) 4.

[123] FSA, DP 05/4 (n 11) 50.

[124] <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>.

[125] FSA, DP 05/4 (n 11) 50.

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