

Valuation – Best Business Practices for Hedge Fund Managers

Recently Jefferson Wells and Alston & Bird LLP hosted a roundtable event on the subject of hedge fund valuation. The attached information highlights some of the key points discussed. Our industry specialists who participated in the discussion consisted of Aileen Doherty – Engagement Manager, Jefferson Wells; Dr. Susan Mangiero – Managing Member and founder of BVA, LLC and Pension Governance, LLC; Tim Selby – Partner, Alston & Bird LLP; and Catherine Duke – Associate, Alston & Bird LLP. The panel was moderated by Gail Robyn Hodes – Professional, Jefferson Wells. Following are the questions that were presented to the panelists and a summary of the responses of each panel member. We invite your comments and look forward to hearing from you.

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Question I. When does valuation become an issue for a hedge fund manager?

Dr. Susan Mangiero (SM/BVA)

Valuation is a cornerstone of hedge fund operations. There are countless activities which are affected by incomplete or inaccurate valuation numbers. This point about the importance of valuation numbers cannot be emphasized enough. If you use bad valuation numbers, it adversely impacts all decisions that follow. For example, if you try to reallocate monies within a fund, poor valuation numbers may result in over- or under-weighting instead of achieving what should otherwise be an optimal allocation mix.

Areas impacted by hedge fund valuation include:

- Fund Creation
- Performance Reporting
- Compensation
- Subscriptions
- Redemptions
- Liquidation
- Risk Management
- Asset Allocation
- Litigation
- Compliance
- Audit
- Divorce
- Succession Planning
- Partnership Restructuring
- Key Person Insurance
- Charitable Contribution

Tim Selby/Catherine Duke (Alston & Bird)

Valuing illiquid securities represents the most significant challenge for hedge fund managers. For example, market price is often unsuitable for certain over-the-counter derivative instruments and structured or distressed securities. Prices may not be available from data-vendors for certain securities because the securities are “one of a kind” or not actively traded. How hedge fund managers value such illiquid securities carries through to two key areas – determining net asset value (NAV) for subscriptions and redemptions, and calculating managers’ fees. In the first instance, overly liberal valuations may unduly inflate the subscription price, while overly conservative valuations may prove unfair to current or redeeming investors by undervaluing the true worth of their investment. In the second instance, there are conflicts of interest challenges as managers have an incentive to inflate the value of difficult-to-value securities for purposes of calculating their performance and management fees. With the Securities and Exchange Commission’s (SEC) heightened attention to hedge

funds, managers must be increasingly proactive in deploying best practices in managing their business.

Aileen Doherty (AD/JW)

Client disclosure. The SEC has cited industry valuation practices and the need for greater transparency to investors of valuation procedures as a key area of concern. Hedge fund managers must establish and disclose to their clients precise written procedures, inclusive of the manner in which exceptions to general policy are made and conflicts mitigated, for determining the valuation of the assets of the fund. Managers must also actively insure that their valuation policies as set forth to their clients are effective, supervised and documented.

Question II. Who should conduct and oversee the valuation process?

AD/JW

From a legal perspective, the funds' general partners (U.S.) or board of directors (offshore) has a fiduciary responsibility to provide accurate and appropriate valuations. While the general partners or Board may delegate valuation calculation to third-party agents, they remain ultimately responsible for insuring that valuations are accurate.

TS&CD (Alston & Bird)

There are various parties – both internal and external – capable of assisting fund managers with valuing illiquid securities. These parties include the:

- Auditor
- Prime Broker
- Investors (including funds of funds)
- Investment Manager
- Administrator
- Board of Directors

The roles of each party as well as the hedge fund's pricing and valuation policy should be formalized in the fund's offering documents.

Question III. What are the pros and cons associated with these choices?

TS&CD (Alston & Bird)

As previously discussed, there are several parties capable of helping fund managers value illiquid securities. And, there are pros and cons associated with each party. In certain circumstances, it may make sense to use more than one source or to use difference sources as the situation requires. However, a manager must be careful not to choose a source simply because it provides a valuation that would be most beneficial to the manager. The chart below

highlights factors to consider in assessing the pros and cons of each party in the valuation context.

Valuator	Pros	Cons
Auditor	Possesses audit and accounting Skills	Not an appraiser
Prime Broker	Expert in executing security transactions and possesses advanced technology	Has already made some judgment on the portfolio value in extending credit
Investor	Knowledgeable about securities; likely does recurring diligence	Does not have access to all relevant information
Investment Manager	Most knowledge about the securities and appropriate valuation factors	Valuation directly impacts performance-based fees
Administrator	Possess portfolio accounting skills; perceived as a reliable third-party	Theoretically independent, but serves as internal accountant to the funds
Accredited Appraiser	Has specialized valuation training; is independent; charges on a project basis	Not all appraisers have knowledge or experience in trading securities
Board of Directors	Has fiduciary obligations to investors	May have limited knowledge or experience in trading securities; selected by the investment manager

Question IV. What are the essential elements to a valuation policy?

AD/JW

There are four basic rules for assessing any compliance issue – particularly valuation:

- Be Alert (*i.e.*, trust no one). Senior management must establish checks and balances, inclusive of supervision by management, of the valuation process;
- Follow History (and compare your story with the one making news). Best practices are consistently changing. Managers need to stay plugged in to any changes be it regulatory or business conduct;
- Use Common Sense: the smell test is generally an accurate indicator – go with your instincts and follow up on areas of concern; and
- Review: The SEC wants to see managers take an active role in the management of their compliance program. Key to this is a regular review and assessment of a program against industry standards. Any

modifications to industry standard and regulatory requirements need to be incorporated into the compliance program.

TS&CD (Alston & Bird)

Fund managers should establish a clear method for valuing illiquid securities. This method should be consistent, reproducible, transparent and verifiable. It is not sufficient to merely have a policy – the results must be reproducible by subsequent evaluators. Key recommendations follow:

- Establishing policy. Hedge fund managers must formalize the manner and frequency of computing a fund's net asset value and make appropriate disclosures in the offering documents.
- Separating duties. Portfolio managers should not be responsible for marking their own books at month-end and should not directly compensate those who do.
- Documenting processes. It is inevitable that judgment calls will be made in determining the value of an illiquid security. Hedge fund managers should document the justifications for these judgments, include these justifications in the month-end materials and make them available for inspection.
- Supervision. Senior management should actively oversee and supervise valuation procedures and be made aware of any exceptions.
- Consistency. Frequent changes in the valuation process, analytical tools or data sources used are red flags for potential problems. Any changes should be supported with documented rationale.
- Verification. Mistakes are made, so provide checks and balances.

Question V. Can you detail a specific case?

AD/JW

The SEC recently brought sanctions against parties involved in calculating valuations for certain hedge funds managed by Lipper & Co. LP (Lipper), an investment adviser registered with the SEC. According to SEC allegations, a former portfolio manager affiliated with Lipper inflated the valuations of four of the firm's convertible hedge funds from 1998 to 2002. The manager was convicted, sent to prison and fined \$89 million for fraud. The SEC also initiated proceedings against the external auditor of the fund for unquestioningly relying on a valuation process that was significantly flawed. The gross valuation misstatements became evident only after the manager left Lipper, and senior management began reviewing his prior valuations.

The above is a classical example of what happens when simple checks and balances are not present in the compliance process. Lipper's process was weak, lacked separation of duties and senior management oversight. The written policy did not address exceptions nor require justifications and documentation for setting valuations that differed from market consensus. Had

senior management been more actively involved, the manager would not have been able to manipulate the valuation numbers for such an extensive period of time. This was an inherent conflict, as the manager would benefit from performance fees, that was not mitigated and supervised.

Question VI. What are investors are looking for in a valuation policy?

SM/BVA

Fiduciaries of institutional investors, notably pension plans, are under intense scrutiny to evidence that they have done sufficient research and analysis before deciding on a particular investment. Since valuation is integral to effective investing, care must be taken to ensure that the valuation process reflects characteristics such as those listed below. Related, but different, a valuation analysis must likewise exhibit certain characteristics as a hallmark of quality. This list below is not exhaustive.

- A valuation of an economic interest should be done by an independent and objective third party.
- A valuation engagement letter must specify exactly what is to be valued, the purpose of the valuation, the effective valuation date, the standard of value (fair value, fair market value, liquidation value, etc).
- Standard of value is one factor that determines whether (and what) adjustments (premiums, discounts) should be made.
- Every detail counts with respect to appraising a particular economic interest, including, but not limited to, anything that restricts transferability from the current owner to someone else.
- A quality valuation process should: (a) reflect independent and unbiased opinions of value (b) be well documented (c) make economic sense (d) reflect activities that can be replicated and/or verified by someone else such as an auditor (e) be regularly reviewed and modified, as appropriate (f) prohibit appraisal fees that are tied to valuation results and (g) ensure that valuations are done by parties without a conflict of interest or economic interest in the outcome.

Question VII. Should a Trustee think about valuation when considering a hedge fund that employs derivatives?

SM/BVA

While not an attorney, and therefore not in a position to provide a legal interpretation, the general idea is that trustees must do their homework before committing monies to hedge funds. This is a comprehensive exercise which requires those in charge to ask a lot of questions about fund transparency, liquidity, valuation processes, performance, risk-return tradeoff, suitability, etc. Outsourcing the asset allocation decision to external parties does not absolve fiduciaries from their responsibility to select and monitor managers, at the outset and on a regular basis thereafter. With respect to a fund's use of derivatives,

regulatory guidance is clear. *“If the plan is investing in a pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances.”*

“In determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan's investment policy, what role the particular derivative plays in the plan's portfolio, and the plan's potential exposure to losses. While derivatives may be a useful tool for managing a variety of risks and for broadening investment alternatives in a plan's portfolio, investments in certain derivatives, such as structured notes and collateralized mortgage obligations, may require a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments. Characteristics of such derivatives may include extreme price volatility, a high degree of leverage, limited testing by markets, and difficulty in determining the market value of the derivative due to illiquid market conditions.”

Based on this text, a fiduciary would be hard pressed to explain why he or she did not ask about the valuation process used by a hedge fund that trades derivatives.

Question VIII. What are some of the practical considerations for valuation of illiquid positions such as type, form, and frequency of data?

SM/BVA

Determinants of fair market value depend on exactly what is being valued. For example, the estimated fair market value of a portfolio of mortgage-backed bonds will rely heavily on interest rate variables such as yield curve shape, past interest rates and the effect on prepayment, etc. In contrast, the determinants of fair market value of a majority ownership stake in a closely-held company will include, but are not limited to, the organizational form of the company, the industry, the quality of management, number and maturity of patents and trademarks, market share, access to capital, dividend distribution patterns, number of owners and degree of control by owner and so on. Data is not always readily available and may differ in quality by type of variable. Even when data can be purchased, it is not always presented in the same way by each vendor. It is critical to understand how the data is prepared so that the resulting opinion of value can be correctly interpreted.

Question IX. What different valuation methodologies are available for difficult-to-value securities? How do they compare?

SM/BVA

Answering this question could easily take up a day or two of discussion. Again, it depends on what exactly is being valued. An appraiser would employ as many methods that apply. Typically (and this is a gross generalization), the valuation of common equity for a profitable company that is assumed to remain in business would require the use of a discounted cash flow method(s) and some type(s) of comparables analysis. If an employee stock option was being valued, the appraiser would consider various option pricing models such as the Black-Scholes and binomial models, among others. Importantly, these comments should not be taken out of context. This is an important question that deserves a more complete answer when time is not an issue and when facts and circumstances are available for a given situation.

Question X. Do you have specific recommendations for difficult to value assets & asset classes?

TS&CD (Alston & Bird)

The following instruments typically pose valuation difficulties:

- Private Securities
- Distressed Debt
- PIPEs
- Derivatives

There are various alternatives available to hedge fund managers for determining valuations for difficult to value securities. In some instances, hedge fund managers may choose to develop internal pricing models. In these cases, managers must be able to explain and support the model parameters used in determining the valuation. These internal valuation models should be continuously tested, and where possible, independently reviewed and verified. Alternatively, managers may opt to obtain pricing information from an independent pricing service which provides a market value or assists the fund to establish a fair value. For example, prime brokers and third-party administrators often provide valuation services as part of a services package.

Question XI. What are the legal, accounting and structuring issues and implications when using “Side Pockets”?

TS&CD (Alston & Bird)

A current trend among hedge funds is to incorporate the use of side-pockets into their valuation process for difficult-to-value assets. Securities that are, or become, illiquid are removed from the valuation process that is applied to the general portfolio and held either at cost or fair value until a liquidation or valuation-generating event occurs, e.g. held in a “side-pocket”. Any participation in profits or losses from the side-pocket is typically restricted to only those investors who held a position in the fund at the time that the transaction designated for the side-pocket was executed. Such side-pocketing enables the hedge fund manager to avoid the difficult task of valuing an illiquid security each time an investor comes in or withdraws from the hedge fund. This mechanism also protects investors against adverse timing of withdrawals, and effectively reduces the risk of illiquidity issues for limited partners.

However, while side-pockets present an attractive accounting solution for valuing illiquid assets, one drawback associated with side-pockets is that portfolio components are ignored. For example, from a risk management perspective, diversification numbers may not accurately capture the true nature of the portfolio. Side-pockets also raise disclosure issues as their use must be included in the organizational documents and marketing materials of the fund and present difficulties for managers with respect to calculating fees.

Question XII. What constitutes “Bad Valuation”?

AD/JW

Bad valuation is the result of a bad valuation process. A good process is comprised of:

- (1) Written Policy
- (2) Checks and Balances to Avoid Conflicts
- (3) Concrete Ways to Evaluate Effectiveness and Ensure Frequent Reviews by Senior Management
- (4) Rules to Permit Disciplined Reviews for Accuracy

Any process that does not contain all of these elements has a high likelihood of breaking down resulting in compliance issues.

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Common valuation errors include any or all of the following. This list is not exhaustive.

- Exclusion of Valuation Date and/or Date of Preparation
- Absent or Ill Defined Purpose of the Valuation
- No Specification of Standard of Value (e.g. Fair Market)
- No Site Visit
- Exclusion of Assumptions and Limiting Conditions
- Exclusion of Discussion About Methodological Choice
- Incorrect Normalization of Earnings
- Inappropriate Growth Rate
- Incorrect Capitalization Rate
- Incomplete or Missing Discussion of Comparables Analysis
- No Discussion of Empirical Basis for Premiums and Discounts
- Missing Data Source Listing
- Model That Blows Up Under Certain Market Conditions
- Model That is Difficult to Replicate

Question XIII. Are there any valuation standards? Can you explain the different professional credentials and how they compare?

SM/BVA

You can download a comparison credentials chart by visiting the website of the National Association of Certified Valuation Analysts, <http://www.nacva.com>. This document explains some of the various business valuation certifications and associated requirements. It is not a complete listing. For example, it does not include designations such as the Chartered Financial Analyst designation. It is important to note that there are many valuation standards and guidelines. These include the *Uniform Standards of Professional Appraisal Practice*,

Private Equity Industry Group Guidelines, Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry and Sound Practices for Hedge Fund Managers, to name a few.

[Aileen Doherty – Jefferson Wells:](#)

- Attorney and responsible for the development of the Hedge Fund Regulatory and Operational Risk Management practice at Jefferson Wells.
- She brings over 15 years of financial institutional experience having provided Counsel and Compliance oversight at Fiduciary Trust, Citicorp Investment Services and Alliance Capital.
- She also serves on the Governance Committee for 100 Women in Hedge Funds.

[Timothy Selby, Esq. – Alston & Bird LLP](#)

- Partner with the Financial Services and Products Group.
- His practice advises clients on the structure, formation, and management of public and private offerings including; commodity pools, domestic and offshore hedge funds, funds of funds, and private equity funds.

[Catherine Duke, Esq. – Alston & Bird LLP](#)

- Attorney with the Financial Services and Products Group.
- She concentrates her practice in the area of alternative investment products and securities and investment advisor regulation.
- Prior to becoming an attorney, Catherine worked as an Investment Banker at Prudential Securities, an Analyst at BlackRock Financial and in the Client Services area of Lazard Asset Management.

[Gail Robyn Hodes – Jefferson Wells](#)

- Professional with Jefferson Well's Financial Institutions practice and a NASD Securities Principal.
- With over 12 years of Financial Services experience on both the buy and sell side, she has concentrated on compliance issues for Alternative Investments products at DKR Capital, Deutsche Bank Private Wealth Management and GE Asset Management.
- Gail has her MBA and Six Sigma Quality training.

Dr. Susan Mangiero - BVA, LLC and Pension Governance, LLC:

- Provides valuation, risk analysis and litigation support consulting for pension trustees, regulators, audit and compliance firms, hedge fund professionals, and attorneys
- Over twenty years of experience in capital markets, global treasury, asset-liability management, portfolio management, economic and investment analysis, derivatives, financial risk control and valuation for organizations such as the General Electric Company, PricewaterhouseCoopers LLP, Bank of America and Bankers Trust
- Worked on two trading desks, in the areas of foreign exchange and futures and options
- Accredited Valuation Analyst and certified Financial Risk Manager
- Author of *Risk Management for Pensions, Endowments, and Foundations* (John Wiley & Sons, 2005) and articles for *Hedge Fund Review*, *Investment Lawyer*, *Valuation Strategies*, *RISK Magazine*, *Financial Services Review*, *Family Foundation Advisor*, *Hedgeco.net*, *Expert Evidence Report*, and *Bankers Magazine*