

CONSULTATIVE PAPER

*POLICY STATEMENT ON HEDGE FUND VALUATION*

31 JULY 2007



Financial Supervision Commission Barrantee Oaseirys

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## ***SECTION I***

### ***I. INTRODUCTION***

To assist industry, the Commission proposes to identify, in conjunction with industry bodies, appropriate best practice standards and to issue policy statements from time to time informing licenceholders of the standards which it would expect them to adopt and against which they will be assessed as part of the ongoing supervision process. This consultative paper covers best practice standards in hedge fund valuation.

It would be much appreciated if we could have your response by 21 September 2007.

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## ***SECTION 2***

### ***2. EXECUTIVE SUMMARY***

Recent international comment in relation to the operation of hedge funds (sometimes also referred to as Alternative Funds) has highlighted both the economic benefits and the risks arising from the rapidly expanding hedge fund industry. As part of its work to develop an appropriate regulatory regime for Isle of Man hedge funds, the Commission is concerned to ensure that hedge fund functionaries adopt and implement appropriate best practice standards. To assist industry, the Commission proposes to identify, in conjunction with industry bodies, appropriate best practice standards and to issue policy statements from time to time informing licenceholders of the standards which it would expect them to adopt and against which they will be assessed as part of the ongoing supervision process.

The first such policy statement relates to the valuation of hedge fund assets.

Last year the Isle of Man Fund Management Association issued a document entitled “Sound Practice Guidelines for Administrators of Alternative Funds in the Isle of Man” which the Commission uses as a benchmark for the supervision of the licensed parties involved. Section 6 of that Guidance Note relates to the Net Asset Value Calculation and should be read in conjunction with this Policy Statement.

The Commission also welcomes the recent publication of the draft IOSCO Principles for the Valuation of Hedge Fund Portfolios (“the Principles”) and the Recommendations contained in the Alternative Investment Management Association’s (“AIMA”) Guide to Sound Practices in Hedge Fund Valuation (“the Recommendations”) and endorses both the Principles and the Recommendations as best practice, which it expects to be adopted by Governing Bodies and Managers of funds established, managed and/or administered in the Island.

## **SECTION 3**

### **3. BACKGROUND**

#### **The Isle of Man Hedge Fund Industry**

Although there is no universally accepted legal definition of a “hedge fund” or Alternative Fund, it is generally agreed that a hedge fund is an investment structure that has some or all of the following characteristics:

- High levels of leverage;
- Significant performance fees paid to the Manager in addition to the annual management fee;
- An ability for investors to redeem their interests periodically;
- Significant “own” funds invested by the Manager;
- Speculative use of derivatives and the ability to short sell; and/or
- The involvement of more diverse risks or complex underlying products.

*(See IOSCO’s Report on “The Regulatory Environment for Hedge Funds”, published in November 2006).*

The following characteristics might also be accepted by many as common:

- Alternative and often highly complex investment strategies, including short selling, investment in illiquid assets or assets with uncertain or long-term liquidity, derivative assets which are not quoted on recognised exchanges, derivative synthetic assets which are unquoted and thus hard to value, high concentration or activist investing, multiple intra-day trading, or a combination of these strategies
- Aimed at “institutional” or very high net worth investors;
- Subject to light touch regulation or unregulated, often in the context of a regime where the regulation is aimed at the functionaries rather than the fund itself.

Based on these characteristics, some of the more lightly regulated funds directed at specialist investors as well as unregulated (exempt and closed-ended) funds could be characterised as “hedge funds”. It follows that recent developments in relation to the global hedge fund industry are relevant to Isle of Man funds, albeit that, in common with other jurisdictions, the Island’s legislation as yet contains no definition of that term.

The recent rapid growth of the alternative fund industry in the Isle of Man has been accompanied by a change in the nature of the funds themselves, with a move towards the use of closed-ended listed funds and increasing diversity in the range of “alternative” investment strategies employed. In view of the clear marketing opportunities and the vision and enthusiasm of the industry, the fund sector is likely

to continue to play a major role in the development of the financial services industry in the Island in the short to medium term.

### **The Regulation of Hedge Funds**

However, investment in a hedge fund intrinsically attaches a number of complex and additional significant risks which are not common in an investment in, for example, a highly regulated Authorised Scheme aimed at the retail market. As regulator, the Commission must seek to mitigate these intrinsic risks in the interests of investors and the reputation of the Island. In doing so, it has sought also to support the development of this industry by working closely with the Funds Review Group and the Fund Management Association to develop an appropriate regulatory regime which promotes a balanced approach to regulation, addressing the regulatory risks inherent in the operation and management of hedge funds while allowing the industry the freedom it needs to flourish.

In developing its regulatory approach, the Commission is mindful of the approach taken in other jurisdictions and by the international standard-setters who judge the adequacy of the Island's regime. This is highly relevant to the regulation of the hedge fund industry as its rapid expansion has given rise to increasing and global regulatory and economic interest. Although there is no consistent approach to the regulation of hedge funds, the risks of poor or inappropriate regulation are high. A number of studies have sought to analyse the risks, including the IOSCO report cited above.

There is also increasing evidence of international regulatory initiatives in relation to the establishment of "standards" for hedge fund Governing Bodies (meaning the directors, trustee or partners, as appropriate of the fund company, unit trust, or partnership) and managers. These initiatives include not only the establishment of formal regulatory standards in individual jurisdictions but also a suggestion from the European Central Bank that there should be a "code of conduct" for hedge funds.

The Commission welcomes these international initiatives and equally welcomes the fact that the hedge fund industry itself is seeking to establish "self-regulation" in the form of best practice guidance developed by the industry for the industry. The Alternative Investment Management Association ("AIMA") is currently updating its suite of "Sound Practice" documents. This exercise should be complete by the end of 2007 and is likely to form the basis of further policy statements by the Commission. AIMA has also recently published a new Guide to Sound Practices for Hedge Fund Valuation. This built on AIMA's Research and Recommendations on Pricing and Valuation, conducted in 2005.

This timely development complements the publication by IOSCO in March 2007 of a consultation on proposed *Principles for the Valuation of Hedge Fund Portfolios*. The consultation period closed in June and it is expected that the final statement of the Principles will be published in the autumn.

The purpose of this Policy Statement is to give an early indication to industry that these documents are considered by the Commission to be important benchmarks in best practice in the area of valuations and will be the standard applied by the Commission in assessing relevant licenceholders in the future.

## **SECTION 4**

### **4. PROPOSALS**

#### **Best Practice Standards on Valuation**

##### *The importance of good valuation practice*

Valuation practices and policies are critical to the integrity of hedge fund portfolios. Without appropriate valuation controls investors may be disadvantaged and confidence in the use of hedge funds may be reduced. For example:

- where managers have the responsibility for the calculation of Net Asset Valuations and are also the body providing the individual asset valuations, there is an inherent conflict of interest that should be appropriately addressed;
- a lack of transparency in valuation policies and obtaining independent valuations may deny investors material information and result in a mismatch of expectations and resulting complaints; or
- investment in illiquid assets may lead to subjective or inconsistent valuation policies or processes; similarly, if the use of “side-pockets” (for example, where certain assets are placed in a “side-pocket” and excluded from a fund’s valuation) is not transparent, investors may not know how they are be advantaged or disadvantaged by such a practice or how their redemptions may be affected; or
- an absence of adequate systems to monitor investments.

##### *Why the Commission has chosen the IOSCO and AIMA standards*

IOSCO is the international standard setter against whose standards the Island’s securities regime is assessed, including by the IMF. It is therefore vital that IOSCO principles are taken into account in the regulation of the Island’s collective investment scheme industry.

IOSCO has sought to develop its Principles in close collaboration with industry representatives. AIMA has taken an active, industry led role in developing best standards by the industry for the industry; the overlap of individuals and organisations involved in the development of the AIMA Recommendations and the IOSCO Principles may explain the similarity in approach and the significant overlap between the Recommendations and the Principles. The result is that the two documents together present a robust but common sense approach that should be relatively easy to implement (in so far as these are not already in place) in a way which is sufficiently flexible to address industry, stakeholder and regulatory needs.

### *The IOSCO Principles*

The IOSCO consultation sets out nine principles, which have the stated goal of promoting the consistent application of a set of valuation policies and procedures in the valuation of hedge fund portfolios, and independence in, and transparency of, this valuation process. The principles, which provide a framework for more detailed requirements or recommendations, are designed to cross jurisdictional boundaries and to be adaptable and relevant to a range of hedge fund and service provider structures, while providing appropriate protection for investors. A summary of the IOSCO Principles is contained in Appendix 1.

### *The AIMA Recommendations*

AIMA's recently published 15 Recommendations streamline their original 20 recommendations and are designed to provide principles based guidelines for valuation in the areas of governance, transparency, procedures and methodology. They are intended to form a basis for sound practice across the industry. The Recommendations complement and build on the framework established by the IOSCO Principles in many material respects. The AIMA recommendations are summarised in Appendix 2.

### **Implementation of Best Practice Standards on Valuation**

The Commission endorses the AIMA Recommendations as benchmark standards within the proposed framework of the broader IOSCO Principles and would encourage licenceholders to conduct a self assessment against the Recommendations in preparation for the finalisation of the IOSCO Principles later this year.

**Financial Supervision Commission**  
**31 July 2007**

**The Draft IOSCO Principles  
For the Valuation of Hedge Fund Portfolios**

The nine principles can be summarised as follows:

1. Comprehensive, documented **policies and procedures** should be established for the valuation of financial instruments held or employed by a hedge fund.
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.
3. The financial instruments held or employed by hedge funds should be **consistently valued** according to the policies and procedures.
4. The policies and procedures should be **reviewed** periodically to seek to ensure their continued appropriateness.
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.
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.
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.
8. The Governing Body should conduct initial and periodic **due diligence** on third parties that are appointed to perform valuation services.
9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be **transparent** to investors.

**The AIMA Recommendations  
In relation to Sound Practices in Hedge Fund Valuation**

The AIMA Recommendations can be summarised as follows:

***Governance***

1. In advance of the Fund's launch a summary of practical, workable pricing valuation practices, procedures and controls should be enshrined in a **Valuation Policy Document** and approved by the Fund's Governing Body, after consultation with relevant stakeholders. The Valuation Policy Document should be reviewed on a regular basis by the Governing Body.
2. The Valuation Policy Document should explicitly clarify the **role of each party** in the valuation process, should identify **price sources** for each instrument type and should include a practical **escalation or resolution procedure** for the management of exceptions.
3. The Governing Body of the Fund should ensure **adequate segregation of duties in the NAV determination process**, which may be achieved by delegating the calculation, determination and production of the NAV to a suitably independent, competent and experienced **Valuation Service Provider**. If the Investment Manager is responsible for determining the NAV, and/or acts as the Fund's Governing Body, robust controls over conflicts of interest should be established.
4. **Oversight** of the entire valuation process and, in particular, resolution of pricing issues associated with hard-to-price illiquid positions and exotic instruments remains the ultimate responsibility of the Fund's Governing Body.

***Transparency***

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

### *Procedures, Processes and Systems*

8. The procedures enshrined in the Fund's Valuation Policy Document should be designed to ensure that the **parties controlling the Fund's valuation process are segregated from the parties involved in the Fund's investment process.**
9. The industry recognises that in certain instances the Investment Manager has the best insight with respect to the valuation of particular instruments. Wherever prices are provided or sourced by the Investment Manager, the Valuation Service Provider should be furnished with **sufficient supporting information by the Investment Manager.**
10. Procedures described in the Valuation Policy Document of the Fund must be capable of **practical implementation** by the Valuation Service Provider.
11. The Valuation Service Provider should use reasonable endeavours to apply any pricing policy **consistently.** Deviations from the policy should be approved by the Governing Body in advance of any NAV being released.

### *Sources, Models and Methodology*

12. Wherever possible the valuation of each position in the Fund's portfolio should be checked against a primary and secondary price source. The Valuation Policy Document should outline the **hierarchy of sources** to be used for each security type and the **tolerance levels** for variances between the sources.
13. If the Governing Body approves the use of **broker quotations** for the valuation of certain instruments, these quotations should wherever possible be multiple, sourced consistently and accessed by the Valuation Service Provider independently without intervention by the Investment Manager.
14. Any decision to use a **pricing model** should be approved by the Governing Body and should be properly justified by appropriate testing. If an Investment Manager's pricing models are used they should be independently tested and verified.
15. Any decision to allow the **side-pocketing**[Need to define this term?] **of illiquid/hard-to-value positions** should be taken only after careful consideration by a Fund's Governing Body. If the Governing Body approves such a decision it should ensure that side-pocket policies are clearly communicated to all investors. The criteria for side-pocketing individual positions should be as consistent as possible.