

Valuation

Hedge Fund Valuation Pitfalls and Best Practices: An Interview with Arthur Tully, Co-Leader of Ernst & Young's Global Hedge Fund Practice

By Jennifer Banzaca

Ernst & Young recently released the provocative results of its annual hedge fund survey entitled, "Coming of Age: Global Hedge Fund Survey 2011." The survey polled hedge fund managers and investors on a range of relevant topics, notably including valuation and the use of administrators. See "Ernst & Young Survey Juxtaposes the Views of Hedge Fund Managers and Investors on Hedge Fund Succession Planning, Governance, Administration, Expense Pass-Throughs and Due Diligence," *The Hedge Fund Law Report*, Vol. 5, No. 1 (Jan. 5, 2012). Many of our subscribers are profoundly interested in the topics of valuation and administrators. Accordingly, we recently interviewed Arthur Tully, the Co-Leader of E&Y's Global Hedge Fund Practice, to dig deeper into the survey results on these two topics, and to go beyond the survey to explore Tully's extensive experience in these areas. Our interview covered a range of topics on which HFLR subscribers have requested additional insight, including: the level of comfort that investors should take in an administrator's valuation of Level 3 assets; the level of interest on the part of investors in independent reconciliation of a hedge fund's investment positions to custodians and prime brokers; who pays for "shadowing" of an administrator by a hedge fund manager and alternatives to shadowing that can provide the same level of comfort to investors; how managers can reconcile and document differences between their calculations of NAV and administrators' calculations of NAV; independent administration considerations for UCITS funds; the interaction between valuation firms and administrators; hedge fund manager valuation committees;

the roles of the board of directors and chief compliance officer in the valuation process; what SEC examiners are looking for with respect to valuation; and how to gather the data necessary to complete Form PF. The full text of our interview with Tully is included in this issue of *The Hedge Fund Law Report*.

HFLR: Your 2011 "Coming of Age" survey of global hedge fund managers and investors uncovered an interesting and potentially costly misalignment of expectations among hedge fund managers and investors with respect to valuation by administrators. On the one hand, 74% of investors consider it important that a hedge fund manager completely outsource valuation to an administrator. On the other hand, 71% of hedge fund managers perceive at least some risk in such outsourcing, and – probably as a result of that perceived risk – 84% of managers shadow administrators that calculate and issue NAV for their funds. Given the skepticism on the part of managers, what level of comfort should investors have in an administrator's valuation of a hedge fund's investments?

AT: From what we've seen over the years, I would say investors should take a fair amount of comfort in the valuation work that administrators do. The area where administrators still need to do more work is with Level 3 assets. But, when it comes to Level 1 and Level 2 assets, there is a fair amount of comfort that investors should be

able to take. There just needs to be more focus on Level 3, which is an issue for everyone, including the managers and accounting firms. There's always more pressure on the amount of work that needs to be done around Level 3 assets. The administrators are trying to address the issue, as they should, and they are continuing to beef up their efforts in properly valuing Level 3 assets.

HFLR: Your survey also found that: First, just one in four managers or investors is confident that administrators can effectively and accurately value Level 3 assets; second, many administrators do not have the resources to value independently complex securities and Level 3 assets; and, third, “most administrators currently do not take responsibility for valuation.” In light of the resource and expertise limits on the part of administrators with respect to valuation of complex or illiquid assets, who can managers and investors turn to for a third-party check on valuation?

AT: The primary responsibility for the valuation lies with the manager. The investor needs to look to the manager for that comfort. You always have the work that's done by the administrators, which is part of the process, but the investor really needs to look to the manager in terms of what the manager does. For Level 3 assets, the administrators don't necessarily have all the resources necessary to value those independently. I would say though, as part of best practices, we have seen some administrators beefing up their ability to independently value Level 3 assets by hiring the resources that are capable of independently valuing them. But, there are many administrators that are not at that point yet. So, investors do need to look to the manager's valuation process, in terms of getting the comfort that they want over Level 3 assets.

There are third party valuation firms out there that the managers can hire as well, apart from the administrator, to provide that comfort to investors. Managers are engaging them more and more.

HFLR: Interestingly, your survey noted that few hedge fund managers or investors identified independent reconciliation of a hedge fund's investment positions to custodians and prime brokers as a key benefit of the administrator. Is this because investors are no longer very concerned about such reconciliations; or is this because other parties – for example, prime brokers and custodians – are performing this service themselves; or is this for another reason?

AT: If you go back a few years, when the Madoff situation happened, investors became overly concerned about independent reconciliation. As a result, there was a concerted effort on the part of the industry whereby the administrator started providing more and more transparency to investors, which included information around independent reconciliation of positions. I would say the concern is still there, it's just not there to the level it was a few years ago when the Madoff situation occurred. Investors are still focused on reconciliation, but they are focused on other things, like risk management and valuations, a little bit more.

HFLR: Your survey found that a significant percentage of managers are “shadowing” their administrators, that is, performing the same work across a range of functions, such as calculation of NAV, investment valuation, trade processing and reconciliation, P&L production and allocation, etc. Moreover, you found that most such shadowing is done to mitigate the risk of error by the

administrator. (Other, less frequently cited rationales include mitigating business continuity risk and the need to keep separate records.) First, who is paying for such redundant costs: managers or investors? That is, are administrator fees and the cost (i.e., salaries) of management company employees performing shadowing functions typically borne by the management company or the funds?

AT: For the administrator's fees, they are always a charge to the fund. For the cost of shadowing done by the manager, those are largely costs borne by the management company. We have seen a little bit of a shift in some of those costs being redistributed to the fund, based upon discussions with some significant investors. But, largely, the cost of shadowing is something most investors don't want to pay for and is therefore borne by the management company.

The reasoning behind attributing the costs to the fund and determining how much of those costs will be borne by the fund is an evolving process. I can only say that more and more managers are engaging in conversations with their investors in terms of the costs that the management companies are paying. As you can imagine, the costs continue to go up while there is continued pressure on fees. What's happening is managers are having more and more conversations with investors around certain types of costs that are a direct benefit to the fund and whether the fund will pay for some of those costs.

HFLR: Second – and regardless of whom ultimately bears the cost – is there a way that hedge fund managers can give investors comfort with respect to the “shadowed” functions without incurring redundant costs? That is, how can

managers persuade investors that they are doing a credible and sufficient job at valuation on their own, without incurring the extra cost of third party administration?

AT: First, there is still a significant amount of due diligence that is done by the investors. They look at the operations, the risk management and valuation processes that the managers conduct while doing their due diligence, and that gives them a tremendous amount of comfort. There are also other things they can do around various services that are done by the administrators, like a SAS 70, to give investors that additional comfort over a manager's valuation, risk management and operational processes. I would say though that the SAS 70 is something that is generally only done by the larger managers.

HFLR: If a hedge fund manager shadows its administrator with respect to calculation of NAV and comes up with a different NAV, how should the manager and administrator arrive at the actual NAV that is reported to investors and used to process subscriptions and redemptions, and how should that process be documented?

AT: Before an NAV is published, the manager and administrator need to reconcile their differences between what the manager thinks the NAV is and what the administrator thinks the NAV is. That's essential. They need to be able to appropriately document what the differences were and how they were reconciled to make sure they have a proper audit trail in terms of how the NAV was ultimately calculated and published. Documentation is critical.

HFLR: Are UCITS IV funds required to be administered in-house, and, if so, are investors in UCITS IV funds

nonetheless calling for independent valuation by administrators?

AT: The UCITS funds are not required to have administration done externally, nor are hedge funds. I would say hedge funds evolved whereby investors wanted and were requiring hedge funds to have an external administrator. UCITS funds are a registered product and there isn't necessarily that same pressure that you see for hedge funds to perform the administration externally.

HFLR: Are valuation firms alternatives to administrators with respect to valuation of hedge fund investments, or should they work in conjunction with administrators?

AT: I would say the administrators and the valuation firms do and don't work together. The managers, generally, are the ones that engage the third parties to help them with the valuations. There are administrators that engage independent valuation firms to help them value certain assets as well. So, it is evolving, and we do see managers engaging both administrators and third-party valuation firms and we are seeing, more and more, administrators engaging third-party valuation firms as well – particularly when it comes to Level 3 assets.

HFLR: Should hedge fund managers have a valuation committee, and if so, how should a manager determine the membership of that committee?

AT: The hedge fund manager should have a valuation committee when its funds hold securities that are difficult to value. I would say, when you're into Level 2 and Level 3 assets is when you should be looking at having a valuation committee. Generally, if you're a long/short equity fund that

only has Level 1 assets, you probably do not need to have a valuation committee because the securities are very easily priced so there is very little room to change the price on them. I would say the valuation committee is helpful where there are more complex instruments that are more difficult to value.

As far as the composition, there are best practices out there – the President's Working Group issued best practices around hedge funds that need a valuation committee – and hedge fund managers should follow the industry best practices when it comes to selecting who should serve on the valuation committee. [See "President's Working Group Releases Final Best Practices Reports for Hedge Fund Managers and Investors," *The Hedge Fund Law Report*, Vol. 2, No. 5 (Feb. 4, 2009).] If there is a Board of Directors, the Board can be part of the process in terms of selecting members of the valuation committee and approving committee members.

HFLR: What specific skills should the board look for in identifying members of a valuation committee?

AT: The role of the directors is to make sure the manager is acting in the best interest of investors. So the board needs to make sure the committee members have the expertise to help determine asset values and will put the interests of the investors ahead of those of the manager.

HFLR: What role should the chief compliance officer have in the valuation process?

AT: The chief compliance officer's role, with respect to valuation, is to make sure the firm's policies and procedures are being followed.

HFLR: Are there one or two provisions that you advise hedge fund managers to always have in their valuation policies and procedures?

AT: I think the most important thing for managers is to make sure they are consistent in the application of their valuation policies and procedures.

HFLR: With respect to SEC examinations, are there one or two specific things that SEC examiners are looking for in the course of examinations of hedge fund managers on the topic of valuation?

AT: It comes back to consistency. The SEC is looking to see if managers are consistently applying their valuation policies and procedures.

HFLR: With respect to Form PF, are there specific steps that hedge fund managers should take to timely obtain the information required to complete Form PF from their administrators?

AT: I think they are already doing a lot as it relates to Form PF. Most managers are already in the process of pulling the data together that would be required for Form PF. If they haven't, they need to start right away. But, a lot of managers are already working with their administrators, prime brokers and custodians to identify all the information that is needed to complete Form PF, which is not an insignificant task. It requires a lot of work. [See "Key Legal and Operational Considerations in Connection with Preparing, Filing and Updating Form PF (Part Two of Three)," *The Hedge Fund Law Report*, Vol. 4, No. 40 (Nov. 10, 2011).]

