

AIMA'S GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

MARCH 2007

Contents of Complete Guide

Introduction

Executive Summary

AIMA's 15 Recommendations for Hedge Fund Valuation

Overview of Valuation Issues

Valuation
Hedge Funds
Scope of the Study
Responsibility for Valuation
Independence and Competence
Prudence and Fairness
Consistency and Flexibility
Accounting Standards and Valuation Policies

Recommendations on Governance

- 1 - Valuation Policy Document: Approval
- 2 - Valuation Policy Document: Contents
- 3 - Selection of Valuation Service Provider
- 4 - Escalation Procedures

Recommendations on Transparency

- 5 - Offering Document Disclosures
- 6 - Disclosure of Investment Manager Involvement
- 7 - NAV Reporting

Recommendations on Procedures, Processes & Systems

- 8 - Segregation of Duties
- 9 - Supporting Information
- 10 - Practical Implementation
- 11 - Consistency of Application

Recommendations on Sources, Models & Methodology

- 12 - Multiple Sources
- 13 - Broker Quotations
- 14 - Pricing Models
- 15 - Side Pockets

Appendix 1: About AIMA

Appendix 2: AIMA Asset Pricing Committee & Guide Reviewers

Appendix 3: Hedge Fund Stakeholders

Appendix 4: Fair Value - Accounting Guidelines

Appendix 5: Valuation Policy Document Outline

The full Guide is available for purchase.

Members £15

Non-members £50

Prices exclude postage and VAT, where appropriate.

AIMA's Guide to Sound Practices for Hedge Fund Valuation is not to be taken or treated as a substitute for specific advice, whether legal advice or otherwise. It does not seek to provide advice on any of the issues herein.

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Introduction

It has always been a goal of the hedge fund industry to drive forward initiatives in order to enhance sound practices.

In 2005, AIMA published its research on *Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry*.¹ This ground-breaking study was two years in the making and included a global survey of hedge fund managers, investors and fund administrators. The intention was to gain an understanding of perceptions and practices in this area: topics covered included the use of independent administrators, the range of instrument pricing sources, governance over fund valuation and the various roles of those involved in the pricing function. We issued 20 practical Recommendations for sound valuation practices within the industry.

The study has been well received by the regulatory community. Indeed, the UK Financial Services Authority (FSA) has referred to our work on valuation specifically in its most detailed analysis of the industry.² The International Organisation of Securities Commissions (IOSCO) is scheduled to release, for public consultation, a paper on valuation principles for complex and illiquid financial instruments in the second quarter of 2007.

AIMA believes that the enhancement of sound practices in the area of valuation is an ongoing process, given the evolution of different types of instruments and developments in valuation techniques. In this publication you will find the original 20 Recommendations have been streamlined into 15. Enhancements to the Recommendations have been made to reflect developments in the industry and to remove

any duplication where it may have existed. While a number of Recommendations have been combined or condensed they have not been diluted. The body of the document provides more detailed commentary on the Recommendations, together with practical examples of sound and unsound practice.

AIMA is supported by over 1,100 member companies in 47 countries. The creation of its range of guides to sound practices and its many other initiatives would not have been possible without the contribution of volunteers. For this publication it was also important for us to be able to draw on the experience of a meaningful cross-section of managers, investors, administrators and pricing specialists. We express our most sincere gratitude and appreciation to the authors of this study, each of whom is named in Appendix 2. They expended considerable time and effort to complete Phase II of this important project on valuation practices.

This study has been designed for use by fund managers, investors and all those servicing and providing professional advice to the hedge fund industry. We believe that you will find the study practical and helpful and that AIMA's 15 Recommendations can be adopted as sound practice across the industry.

We welcome your input on any of the items within; please contact info@aima.org.

Olwyn Alexander
Co-chair

Kieran Conroy
Co-chair

AIMA Asset Pricing Committee

1 - Published by AIMA in April 2005. The Executive Summary, containing our original Recommendations, can be found at www.aima.org under Knowledge Centre/Research.

2 - See *Hedge Funds: A discussion of risk and regulatory engagement* (FSA Discussion Paper 05/04, June 2005), especially section 3.92ff.

Executive Summary



Executive Summary

Drawing on feedback after its initial survey of valuation issues in the industry, AIMA has brought together a broad working party of experts, representing all stakeholders in the valuation process, to explore the issues raised in more detail. The working party has sought to streamline AIMA's original 20 Recommendations in order to reflect more detailed representations from stakeholders and to take full account of ongoing developments in the industry, such as the increasing use of side pockets.

The hedge fund industry is global and ever-evolving, embracing a wide range of instrument types and market conventions. A "one size fits all" approach to the valuation of hedge funds would therefore be unwise and unworkable. AIMA's revised 15 Recommendations are not intended to represent a comprehensive or prescriptive set of rules, and may not be optimal or appropriate for all industry participants. Rather, they are intended as principles-based guidelines for valuation sound practices in the areas of governance, transparency, procedures and methodology (there is inevitably some overlap across these headings).

In its 2005 survey of valuation issues, AIMA highlighted the fact that the Governing Body of a Fund has ultimate legal responsibility for the valuation of the Fund's portfolio. In practice, the Governing Body will delegate the responsibility for the production of the Fund's Net Asset Value (NAV) to another party. Throughout this study we refer to this party as the Valuation

Service Provider. The Valuation Service Provider will typically be the Fund's Administrator. The triangular relationship of Governing Body, Valuation Service Provider and Investment Manager will vary from situation to situation, but its dynamics shape the management of the equilibrium between independence and competence which is at the heart of the hedge fund valuation process.

AIMA's 15 Recommendations are reproduced below. The working party's main conclusions may be summarised as follows:

Governance

- All hedge funds should have in place a detailed Valuation Policy Document, approved by the Governing Body after consultation with other stakeholders.
- Conflicts of interest in the valuation process are usually best managed by the appointment of an independent and competent Valuation Service Provider.
- If the Investment Manager is responsible for valuation and/or governance, robust controls over conflicts of interest should be established.

Transparency

- Investors have the right to expect disclosure of any material involvement by the Investment Manager in the production of a Fund's formal NAV.

Procedures, Processes and Systems

- The parties controlling a Fund's valuation process should be segregated from the parties involved in the Fund's investment process.

Executive Summary

- Procedures should be capable of practical implementation and consistent application by the Valuation Service Provider.

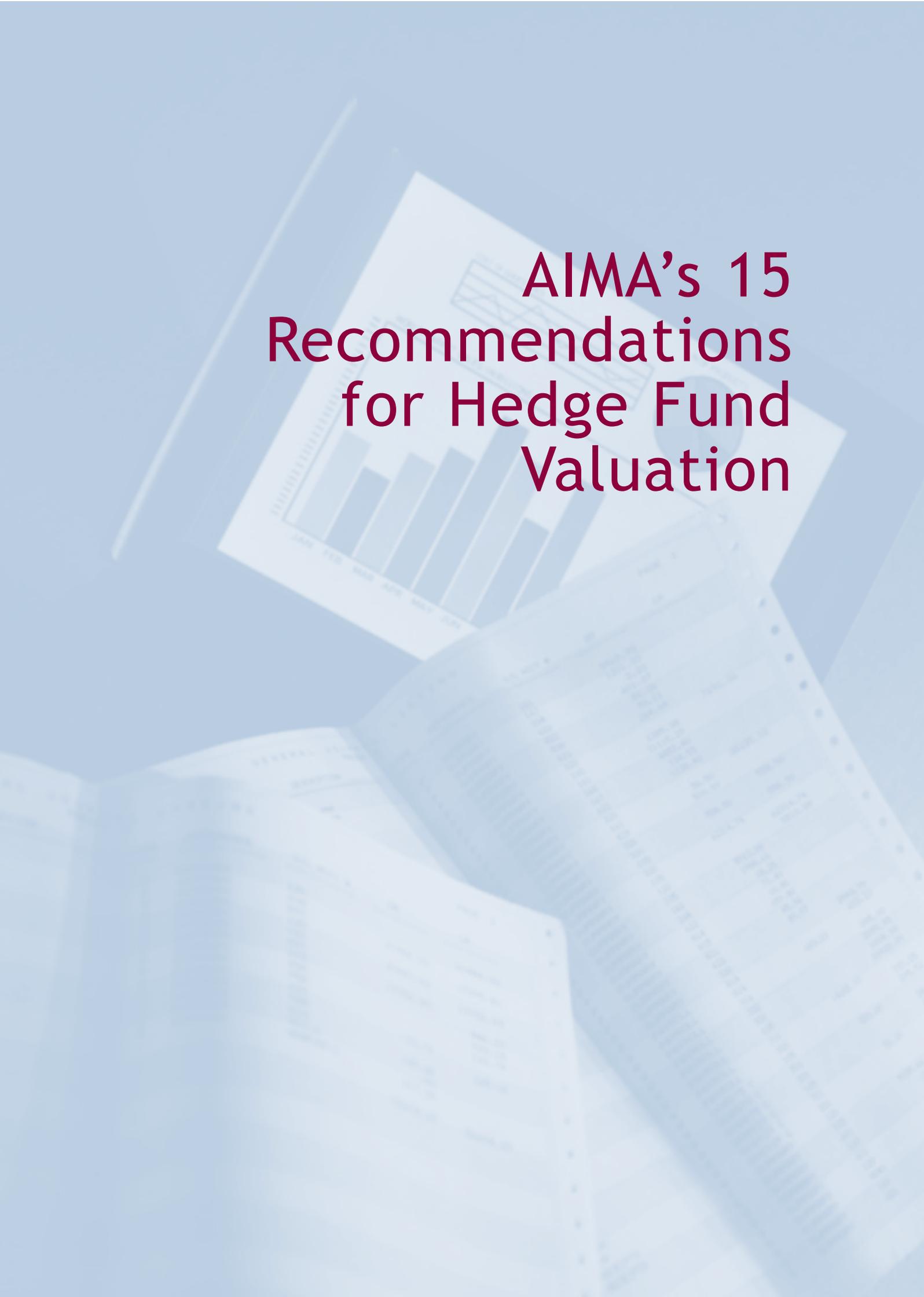
Sources, Models and Methodology

- Wherever possible multiple price sources should be used to verify the valuation of each position in a Fund's portfolio.

- The use of broker quotations and pricing models for formal valuation purposes should be sufficiently tested and controlled.

- Any decision to allow the side-pocketing of illiquid/hard-to-value positions should be taken only after careful consideration by a Fund's Governing Body, who should then ensure that side-pocket policies are properly communicated and consistently applied.





AIMA's 15 Recommendations for Hedge Fund Valuation

AIMA's 15 Recommendations for Hedge Fund Valuation

Recommendations on 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.

Recommendations on 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.

Recommendations on 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.

AIMA's 15 Recommendations for Hedge Fund Valuation

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.

Recommendations on 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 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.





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Enhancing Understanding, Sound Practices and Industry Growth