AIMA'S GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION

MARCH 2007

Alternative Investment Management Association

Contents

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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

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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 and workable 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.

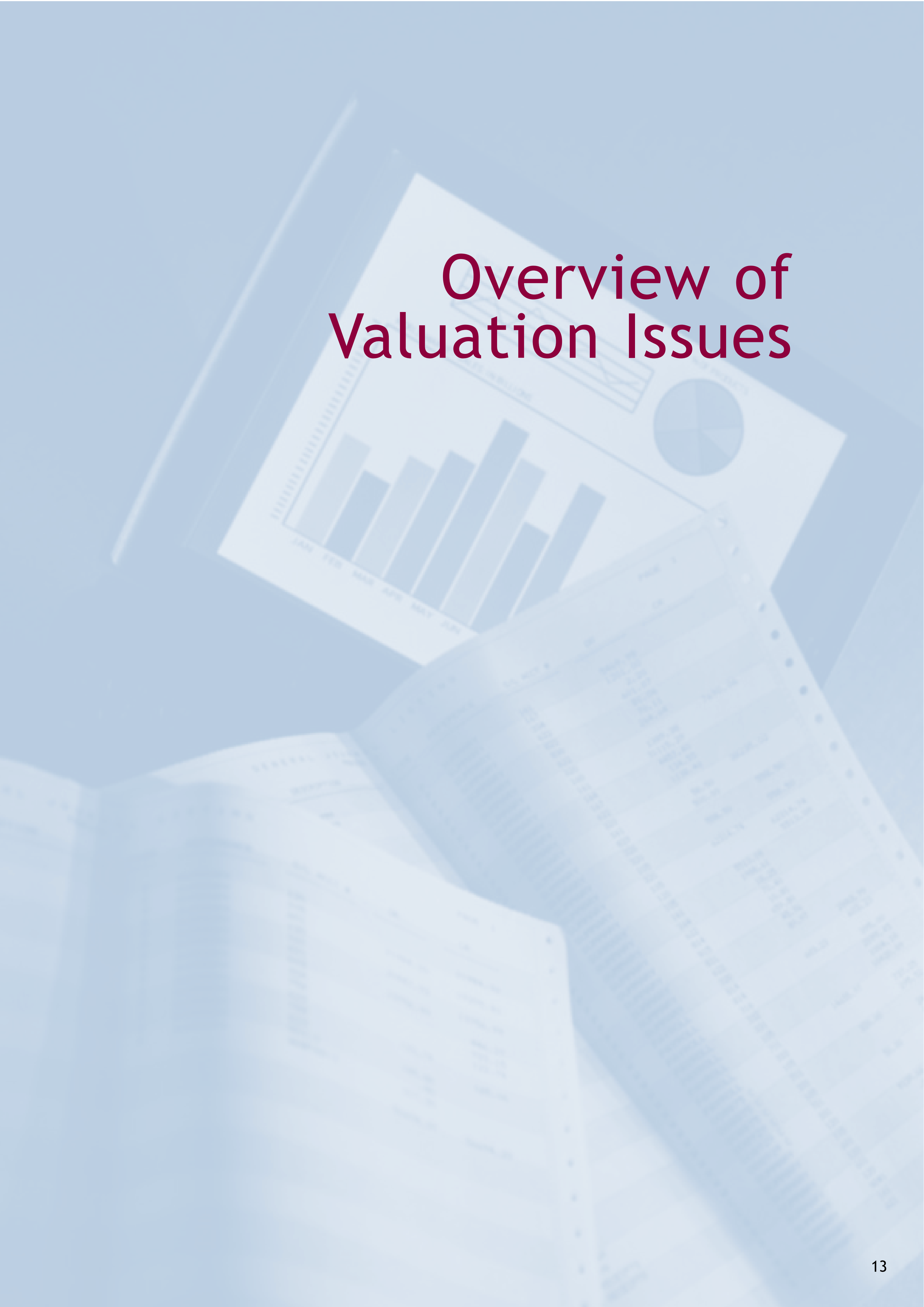
Recommendations on Sources, Models and Methodology

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.



Overview of Valuation Issues

Overview of Valuation Issues

Valuation

For any portfolio of investments, accurate, fair and timely valuation is a prerequisite for asset managers and investors alike.

From a manager's point of view, proper valuation of a portfolio is essential in order to make informed investment and risk management decisions.

From the investor's point of view, fair valuation is the foundation on which analysis of the portfolio's performance and volatility of returns is based. More fundamentally, an investor would normally expect that the amount of cash paid to take an equity interest in the portfolio and the amount of cash received on withdrawal of an equity interest is based on a formal and fair valuation of the portfolio's assets/liabilities.

The absence of procedures and controls in the area of valuation can lead to mis-statements of a portfolio's value, which in turn may have a detrimental impact upon the decision-making processes of managers and investors. In certain scenarios, persistent overstatement of the value of a portfolio's net assets may hide or facilitate misappropriation of those assets.

Hedge funds

The hedge fund industry continues to experience considerable and steady growth, both in terms of the number of individual funds in existence and the assets under management across the sector. Currently, the total assets invested in hedge funds are estimated at approximately $1.4 trillion. As the level of assets increases, continued focus is being maintained by all stakeholders on a number of matters including valuation, risk management, compliance and operational risk.[3]

Much of the debate on these subjects is well-informed and stimulating. There is, however, a strain of sensationalist reporting on hedge funds which assumes that the practices of a handful of unscrupulous operators are prevalent throughout the sector. The more lurid articles caricature hedge fund managers as unprincipled gamblers acting entirely outside any regulatory framework and valuing their portfolios as they please. Such reports are as untrue as they are unhelpful. The vast majority of hedge fund managers behave in a responsible manner and have an obvious vested interest in the ongoing stability of financial markets and the equitable treatment of investors. In the area of valuation, AIMA's previous study demonstrated that opinions and techniques may vary but that most stakeholders understand the issues that arise and seek to address them as diligently as those who operate in other financial sectors. It may also be observed that proprietary desks of large financial institutions and collective investment schemes sold to retail investors have not been entirely immune from instances of misvaluation. Valuation of financial assets is an area where inherent risks can never be eliminated, regardless of how simple the asset class or investment vehicle may appear.

3 - The source for the total assets figure is Hedge Fund Research (data to end of 2006). A list of hedge fund stakeholders is provided in Appendix 3.

Overview of Valuation Issues

It is true that hedge funds have certain characteristics which make the valuation of their portfolios potentially more complex than the valuation of more traditional collective investment schemes:

1. The typical remuneration structure of a hedge fund, whilst aligning the interests of the Investment Manager with the investor in a transparent way, means that the Investment Manager is likely to receive the majority of its fee income for performance, calculated on the basis of the Net Asset Value of the Fund.

2. Because of their sophistication, hedge fund managers are more likely than traditional asset managers to make material investments in complex, hard-to-value instruments, including derivative products and private or illiquid positions.

3. Some hedge fund managers apply high levels of leverage or portfolio concentration, which can increase the materiality of misvaluations should they occur.

4. Hedge funds normally undergo a formal valuation process once a month, whereas more traditional collective investment schemes tend to be valued more frequently.

5. The valuation policies of hedge funds, whilst often very similar, are enshrined in each individual Fund's Offering Document and constitution, and are not subject to a standardised rules-based approach.

These characteristics should be taken into account when considering the level of valuation risk in hedge funds but other features of the industry – and recent trends – are also relevant:

1. A fundamental principle of hedge fund philosophy is that Investment Managers should be substantially co-invested alongside their investors. This kind of alignment, an obvious stimulus for good risk management, is not so prevalent in traditional sectors.

2. As shown by the analysis in the table on page 16, the percentage of hard-to-value assets in hedge funds is difficult to quantify exactly but it is likely to be under a quarter of total assets.

3. In general, hedge funds are currently marketed only to sophisticated investors, who would be expected to appreciate the tensions in the valuation process which we discuss in the following sections. In addition, the scrutiny which these investors bring to bear on the valuation process helps improve practices.

4. Developments in fund administration and specialist pricing services are enhancing the quality of procedures. Some Valuation Service Providers provide daily indicative valuations for a Fund's portfolio, which tend to make the formal month-end Net Asset Value exercise smoother. Pricing specialists have improved their coverage of hard-to-value asset classes so that more hedge fund managers are using their services.

5. There seems to be a discernible trend, in areas such as governance and transparency,

Overview of Valuation Issues

of hedge fund managers embracing sound principles, which they find do not compromise their investment flexibility in the same way as a prescriptive rules-based approach.[4]

Easy-to-Value and Hard-to-Value Strategies

In our 2005 study on Asset Pricing we attempted to give a broad-brush appraisal of the percentage of assets managed in the hedge fund industry which are easy-to-value and hard-to-value.

As was pointed out in that study, such a distinction is somewhat arbitrary in nature given that public information on the instrument types traded by managers in each strategy is limited. AIMA has sought to provide more granularity by estimating the allocation to easy-to-value and hard-to-value instruments by strategies which straddle both types of position. These estimates draw on the experience of the working party and are intended to be conservative. For strategies still allocated entirely to one column or the other, some of the equity strategies may have immaterial allocations to hard-to-value positions, but this is counterbalanced by the fact that many fixed income strategies include quoted, highly liquid instruments in their portfolios.

It should be noted for the sake of consistency that, if the same categorisations were used as in the 2005 study, the percentage of hedge fund assets in the hard-to-value column would have risen only marginally to 22% from 20%.

Strategy	Easy-to-value Assets ($m)	Hard-to-value Assets ($m)
Total	**1,110,114 (77%)**	**326,452 (23%)**
Convertible Arbitrage	22,614 (50%)	22,614 (50%)
Distressed Securities		62,775
Emerging Markets	50,106 (80%)	12,527 (20%)
Equity Hedge	409,038	
Equity Market Neutral	36,096	
Equity Non-hedge	59,208	
Event-driven	154,655 (80%)	38,664 (20%)
FI: Arbitrage		41,375
FI: Convertible Bonds		1,284
FI: Diversified		21,543
FI: High Yield		12,412
FI: Mortgage-backed Securities		29,818
Macro	132,548 (85%)	23,391 (15%)
Market Timing	4,993	
Merger Arbitrage	22,114	
Regulation D		3,424
Relative Value Arbitrage	132,128 (70%)	56,625 (30%)
Sector	72,477	
Short Selling	4,137	

Source for strategy asset totals: Hedge Fund Research (data to end of 2006). Source for allocations to each column: AIMA

4 - For example, whereas our original 2005 survey found that only 38% of hedge funds had a documented valuation policy in place, a recent study now puts the figure at 86%. *See Asset Pricing*, p.15 and *Precautions that Pay Off* (Deloitte Research, 2007), p.12.

Overview of Valuation Issues

Scope of the study

The objective of this document is to further expand on the practical Recommendations covering the formal valuation of hedge funds which were identified in the original *Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry*. Illustrative examples of sound and sub-optimal practice are also provided for each Recommendation. Again, the focus of the study is the valuation of individual hedge funds rather than the valuation of funds of hedge funds.

As in the previous study, we make reference to the Net Asset Value (NAV) of a Fund, as this is the generally understood term for the valuation upon which investor subscriptions and redemptions are based. However, we again concentrate on issues relating to the investment portfolio, rather than the mechanics of expense accruals and performance fee methodologies, as it is issues affecting the Gross Asset Value (GAV) of a Fund that are likely to cause material NAV misstatements. A full Valuation Policy Document would of course address issues, such as income/expense accruals and the calculation of performance fees, which are outside the scope of this study.

While we touch on the subject of controls over the existence of investments in a hedge fund portfolio (usually achieved by a three-way reconciliation between Administrator, Investment Manager and Prime Broker), we are primarily concerned with specific valuation issues. Furthermore our main focus is not on any informal valuation processes carried out between formal valuations. The portfolios of many hedge funds are valued on a frequent (typically daily) basis by the Investment Manager, and/or some of the funds' service providers. These valuations are produced for a variety of reasons, such as ongoing profit-and-loss reporting, risk management, collateral management/margin calculation, and additional transparency for investors. The valuations are sometimes "struck" to high standards, and are clearly important for the purposes of management and control. While we may refer to these informal valuations in passing we are primarily concerned with the formal month-end process.[5]

Responsibility for valuation

Each hedge fund's Offering Document will set out the guiding principles for the valuation of the assets and liabilities of the Fund.[6] Usually included in these principles is the disclosure that the ultimate responsibility for the pricing of the Fund's assets and liabilities rests with the Governing Body of the Fund. The structure of the governing entity will depend on that of the Fund (see Appendix 3). For hedge funds organised in an offshore jurisdiction the Governing Body is usually a Board of Directors or Trustee; for those organised as limited partnerships the Governing Body is the General Partner (who will often be the Investment Manager or an affiliate of the Investment Manager).

5 - Hedge funds are required by their constitutions to carry out periodic formal valuations of their assets and liabilities. By convention, hedge funds formally value their portfolios at each month-end. Even if a Fund's official dealing days are less frequent than monthly, the monthly valuation should be formal and consistent because the majority of hedge fund investors use monthly NAVs for their analysis of performance and volatility. Of course, if a Fund has dealing days at points in time other than month-end, the production of the underlying NAV should be subject to the same controls as month-end NAVs.
6 - In this Guide we will use the term Offering Document as the generic term for the document in which an offer of equity interest is made by a Fund to investors. In the United States and Asia, such a document tends to be referred to as an Offering Memorandum or Private Placement Memorandum; in Europe, a more common term is Fund Prospectus.

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The practical responsibility for controlling the determination of the Fund's NAV is usually delegated to a third party. Throughout this document we will describe the party performing this role as the Valuation Service Provider. Typically, a Fund's Administrator will be the Valuation Service Provider as part of the services it is contracted to provide for the Fund.

For any portfolio with hard-to-value instruments, the Investment Manager will have some input into the valuation process. In certain circumstances, an affiliate or division of the Investment Manager itself acts as Valuation Service Provider (an arrangement sometimes referred to as "self-administration").

The triangular relationship of the Governing Body, Valuation Service Provider and Investment Manager will vary from situation to situation, but it is fundamental to the dynamics of hedge fund valuation. If the Valuation Service Provider is well-resourced and fully independent of the Investment Manager, the Governing Body may serve in a high-level oversight role only. Where the Investment Manager practices self-administration, investors may look to the Governing Body to act in a stronger oversight role.[7] If both Valuation Service Provider and Governing Body are peripheral influences (or if the Investment Manager acts in their positions), the onus falls squarely on the Investment Manager to convince investors that compensating controls, such as reviews by independent parties, greater transparency and robust segregation of duties, are sufficient to manage its conflicts of interest.

In certain circumstances, Governing Bodies may delegate oversight of the valuation process to a sub-committee or separate committee, usually known as a Valuation Committee (or Pricing Committee). A Valuation Committee may be formed when Governing Bodies conclude that they lack specific valuation experience or when the valuation of the Fund's portfolio is considered complex and requires regular review by an oversight body. The appointment of a Valuation Committee is also common if the Fund is a partnership vehicle as it is one way of mitigating the clear conflict of interest which exists when the Investment Manager is also the General Partner (and therefore the Governing Body) of the Fund.

Independence and competence

The main tension in the valuation of the complex assets which hedge funds sometimes trade is that between independence and competence. It is clearly preferable that the responsibility for the valuation of a portfolio, position by position, is taken by a Valuation Service Provider who is not only independent of the Investment Manager but also has no other interests that materially conflict with its duties to the Fund.

For those hedge funds investing in hard-to-value instruments, however, it is unrealistic to expect that the Investment Manager will

7 - This is one of several reasons why hedge fund Governing Bodies should have sufficient stature. *AIMA's Offshore Alternative Fund Director's Guide* (June 2005) provides guidance on forming a suitably qualified and competent Board of Directors. The Guide is available to AIMA members and institutional investors at no charge, and available for purchase by non-members at aima.org.

Overview of Valuation Issues

have no input into valuation. A third party Valuation Service Provider may not have a detailed working knowledge of pricing methodology for complex derivatives, or direct access to price sources for thinly traded securities. Several established hedge fund managers built up their own administrative infrastructure at a time when there were few Valuation Service Providers with the necessary experience and resources to provide formal valuation services. Some of these Investment Managers argue that the industry has still not evolved to the point where there is a sufficient supply of independent Valuation Service Providers who can determine the NAV of a complex portfolio in a fully competent manner. Managers who favour self-administration also point to the fact that their investors demand the production of month-end NAVs to deadlines which an independent provider might not be able to meet.

AIMA believes that the delegation of NAV production to a suitably experienced third party Valuation Service Provider is usually the optimal solution to the tension between independence and competence inherent in the valuation process. This is not to say that the appointment of an independent provider should be viewed as a panacea for all the risks in the valuation process, nor that other stakeholders in the process should abdicate their responsibilities. Furthermore, as our original Recommendations recognise, there are certain circumstances where a hedge fund portfolio is so esoteric or complex that a Valuation Service Provider related or internal to the Investment Manager may be best placed to value the portfolio. In these cases good governance, transparency and meaningful controls over potential conflicts of interest are all the more crucial. It is certainly not sound practice for a Governing Body to approve self-administration without a clear Valuation Policy Document being in place which outlines robust segregation of the Investment Manager's front and back offices.[8]

AIMA's Recommendations also recognise that, even when a third party Valuation Service Provider is delegated responsibility for the overall NAV production process, material input from the Investment Manager may still be required. Again, in these situations, the role of governance, transparency and robust written procedures becomes all the more important and our Recommendations are designed to provide guidance in these areas. Wherever possible, the input of the Investment Manager should be checked and reviewed by the Valuation Service Provider and/or the Governing Body. Sometimes the valuation of certain instrument types, or the review of the Investment Manager's pricing of the instrument type, is delegated to a third party specialist or to an independent accountant.

Prudence and fairness

Prudence is not only a fundamental accounting concept but a natural attribute of responsible Investment Managers. If there is an element of contingency to the value of an investment because of its illiquidity or the subjectivity of pricing

8 - The very terms "front office" and "back office", used colloquially throughout the asset management industry, implicitly recognise the segregation of duties which should exist between those involved in investment decisions/trading and those responsible for reconciliations/accounting. We will sometimes use these shorthand terms when discussing the internal procedures of an Investment Manager.

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assumptions, many managers are understandably reluctant to mark up a position until there is clear evidence of a substantive and sustainable change in circumstances.

But hedge funds do not have the luxury of automatically applying a conservative approach to valuation. They are usually established as open-ended vehicles, and investors subscribe or redeem at each dealing point on the basis of the same NAV. The value assigned to any particular position will have a direct impact on the number of shares that a subscriber receives or the proceeds which will be paid to an investor who is exiting the Fund.

In this regard, the practice of "side-pocketing" private, illiquid or hard-to-price investments has become more prevalent since AIMA's original survey was released. Side-pocket arrangements segregate such positions from the main pool of assets in a Fund until such time as they are realised or are no longer difficult to price. This approach has its advocates in terms of prudence and fairness to investors, especially given the typical "j-curved" nature of returns on special situations. However, multiple side pockets can be difficult to handle from an administration perspective, difficult for certain investors to accommodate and may even encourage the dumping of impaired assets unless properly controlled. The decision to approve provisions for side-pocketing is not one which the Governing Body should take lightly.

Consistency and flexibility

Stakeholders are entitled to expect that valuation policies are applied consistently so that they can perform analysis in the knowledge that the information goalposts are not being moved unreasonably. A lack of consistency in the application of policies can lead to inaccurate and potentially misleading information being distributed and being relied upon by investors and other third parties. One of the aims of a good Valuation Policy Document is to provide a framework for consistent valuation policies and price sources.

However, because of their broad mandates and innovative investment styles, hedge funds may utilise newly-created instrument types and hold positions subject to technical developments or changes in circumstances. Flexibility, usually attractive from an investment point of view, does present challenges from a valuation perspective. When an Investment Manager contemplates investing in an instrument type which has not been included in a Fund's portfolio previously or argues that the most influential market-makers for a thinly traded security have changed, it should engage with the various stakeholders to ensure consensus on the fairest valuation of the position.

Hedge funds are among the main consumers of products developed by investment banks, including complex, specially tailored derivative contracts. In these circumstances a valuation by the counterparty is

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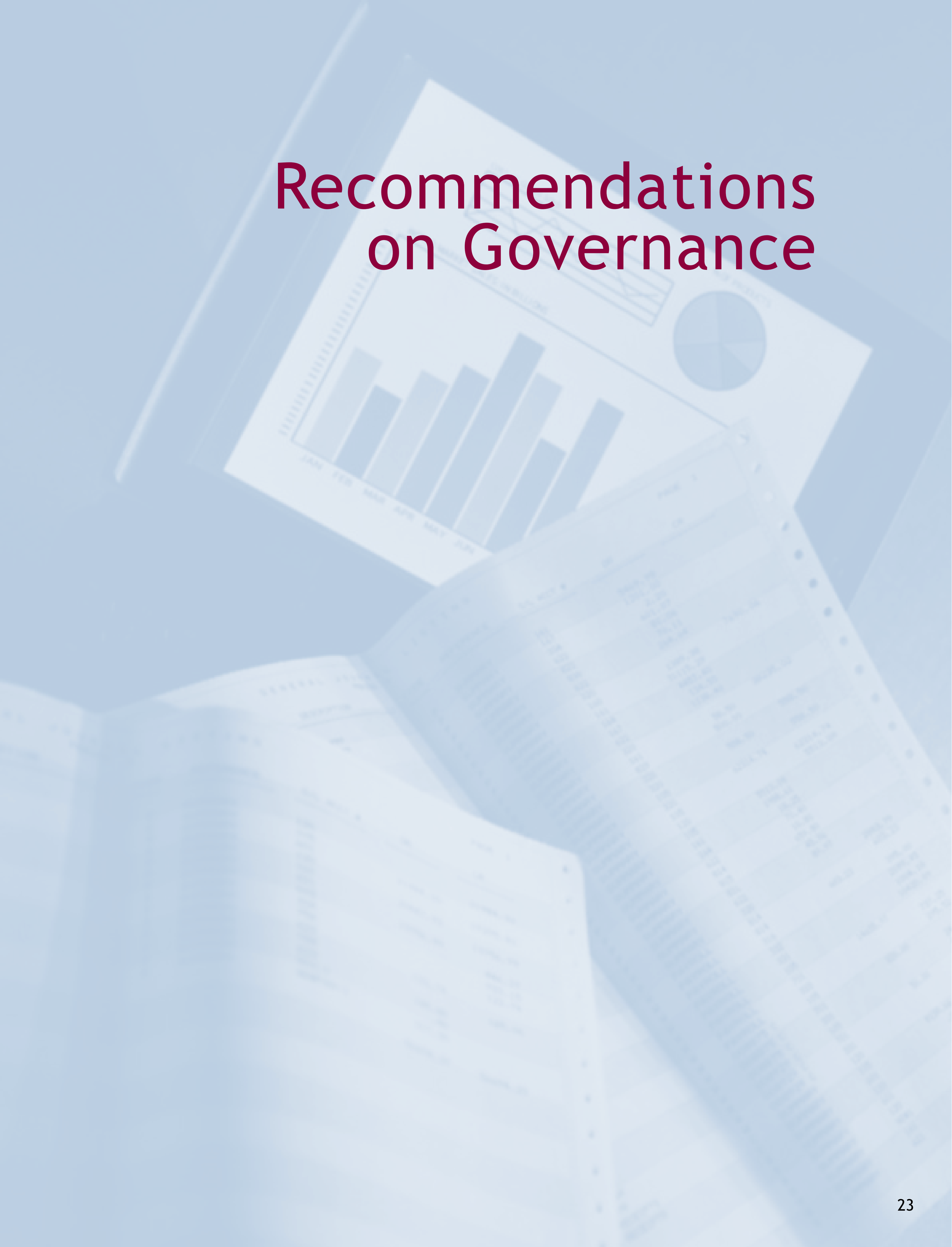
sometimes the only means by which the Investment Manager's own valuation of the contract can be initially verified. In due course, the derivative contract may become a more common way of expressing an investment idea so that the Valuation Service Provider develops its own pricing models or can find another third party specialist with the requisite expertise to provide reliable model-based valuations. This would be a clear-cut instance where a price source consistently used in the past should be superseded by a model giving a more independent estimate of fair value. The industry has demonstrated that it can come to terms with the valuation of new asset classes in this way. Few might have predicted ten years ago that credit derivatives would become as mainstream as they are today.

Accounting standards and valuation policies

The increasing emphasis placed by international accounting authorities on fair value is discussed in Appendix 4. AIMA's Guide seeks to enhance sound practice principles for the fair valuation of hedge fund portfolios. That being said, it is important to re-emphasise the fact that this document covers the valuation of assets for NAV purposes. The requirements and implications of Financial Reporting Standards and, in particular, International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP), have been considered in the preparation of this Guide. However, there will be instances where the valuation of the Fund's assets for the purposes of the NAV calculation will not necessarily comply with the requirements of IFRS or US GAAP. For example, IFRS mandates the use of bid quotations for long positions and ask quotations for shorts, whereas many hedge funds use either the last traded price or, in some circumstances, the middle of the spread. Additionally, US GAAP precludes the use of blockage discounts where an exchange-traded price is available, regardless of the liquidity of the position. The guidelines contained in this document, with accompanying examples, are intended to represent current sound practice and therefore will be revisited and, if necessary, revised to reflect changes in accounting standards or international regulation.

Recommendations on Governance



Recommendations on Governance

Valuation Policy Document : Approval

1 - In advance of the Fund's launch a summary of practical and workable 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.

Regardless of how simple a Fund's valuation practices may appear, proper documentation of the valuation process removes scope for dispute or uncertainty in the future and provides a clear framework for governance in the area.

By convention, the Offering Document which a Fund issues to its prospective investors before and after its launch contains a section on valuation. These disclosures are important and are discussed under Recommendation 5. However, they do not usually address the detail of the practices and procedures applied in the production of the Fund's formal month-end NAV. Inclusion of such detail would probably require the Offering Document to be frequently revised, costing the Fund's stakeholders time and its investors money. While it is therefore reasonable for a Fund's Offering Document to provide a high-level overview of valuation policies, this should be on the understanding that a more detailed summary of valuation procedures is in existence and available for review.

The Fund's Governing Body should therefore ensure that a written Valuation Policy Document is in place for the Fund. Ideally, the Document should be approved before the Fund's launch after consultation with all relevant stakeholders. For a Fund with hard-to-value securities, it is sensible for the Fund's Auditor to be involved in the consultation process, given that it will be performing work on valuation policies and procedures in its year-end audits.

The regularity of review of the Valuation Policy Document by the Governing Body will depend upon the Fund's complexity. Sound practice would be to review the Document at least annually and in any case when the Fund's activities involve new types of instrument. Developments in accounting standards or valuation practices should also be reflected in the Document on a timely basis.

✔ For a Fund likely to have an allocation to quasi-private positions, the Governing Body arranges dialogue between the Investment Manager and the Auditor to discuss the information and documentation the latter will require in its year-end audit fieldwork. For debt positions secured on property portfolios, the two parties agree on using annual reports from an independent property valuation specialist. The Valuation Policy Document then states that the same specialist will be consulted on a quarterly basis to ensure that the carrying value used for NAV purposes remains reasonable.

Recommendations on Governance

✖ A Governing Body is persuaded that there is no need for a Valuation Policy Document at all because "the securities in the portfolio are normally 100% exchange-traded and easy to price". This leads to a variety of practical issues going forward. For example, there is an ongoing issue because of a suspension of dealing in a particular security. Stakeholders in the valuation process have no guidelines to follow and the Investment Manager persuades the Valuation Service Provider to process an arbitrary write-down of the position in a month-end NAV calculation.

Valuation Policy Document: Contents

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.

The Valuation Policy Document should be worded as clearly as possible and should act as a practical guide for all stakeholders involved in the formal NAV process. The Valuation Policy Document may also include guidelines for the delivery of information or completion of a process, although this is more related to the service levels agreed between the parties.

For the accuracy of the NAV process specifically, it would be sound practice for a Valuation Policy Document to include guidance in the following areas, where applicable:

- The responsibilities of the parties involved.
- The forums for, and frequency of, oversight of the valuation policies.
- An outline of the approval process for the use of pricing models.
- An outline of the process for formulating policies when the Fund starts to trade a new investment type.
- The accepted valuation processes, price sources and cut-off times for each type of instrument expected to be traded by the Fund.
- The accepted tolerance levels for any differences between price sources, both at position and portfolio level.
- A definition agreed by all stakeholders of what constitutes a "stale" price.
- For each type of hard-to-value instrument, a methodology or procedure for arriving at a consistent valuation to be included in the NAV, outlined as clearly as possible.
- A clearly defined escalation or resolution process for situations in which tolerance levels are breached, or where the degree of subjectivity in pricing is such that the Governing Body should periodically review in detail.

An example outline of a Valuation Policy Document is given in Appendix 5.

✔ A Fund has a policy on hard-to-value convertible bonds where quotes from third-party market-makers are sourced. Its Valuation Policy Document clarifies the number of quotations to be procured, the method by which the Valuation Service Provider receives the quotations, and the way the average price is to be calculated. If there is a deviation from the written policy, the valuation automatically becomes a reserved matter for the Governing Body.

Recommendations on Governance

✖ A Valuation Policy Document contains clear detail on the price sources to be used for each security type. However, there is no guidance as to acceptable tolerance levels if the price sources differ. This means that the Valuation Service Provider takes unilateral decisions as to whether or not to escalate a difference between the price sources to the Governing Body.

Selection of Valuation Service Provider

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.

However difficult it may be to strike a balance between independence and competence in the area of valuation, a fundamental principle of governance is that the NAV of a Fund should be produced independently of the Investment Manager or that there should be effective controls over NAV production in the cases where the Investment Manager is responsible for valuation.

Independent Valuation Service Providers

If the Governing Body of a Fund chooses to delegate the production of the month-end NAV to a Valuation Service Provider it should conduct sufficient due diligence on any prospective candidate before committing the Fund to any relationship.[9] In practice, there may be a "beauty parade" during which the qualifications, competence and suitability of the providers are assessed. The Governing Body may expect each candidate to supply:

1. Evidence of the robustness of its control environment (this may take the form of an independent accountant's SAS 70 or AAF01 / 06 report).[10]
2. Access to the senior personnel of the Valuation Service Provider who will be responsible for managing the valuation process.
3. Evidence of experience in valuing the instrument types which the Fund trades (this may include references from other hedge funds which trade the same instrument types).
4. Evidence of sufficient systems, infrastructure and business continuity to support the valuation process.
5. Evidence that any internal conflicts of interest are sufficiently managed (for example, a Valuation Service Provider with a prime brokerage arm should ensure that information firewalls exist between the two divisions of the organisation).

During the due diligence process, members of the Governing Body will probably rely on advice and guidance from the Investment Manager but they will retain ultimate discretion over the decision.

9 - See *AIMA's Illustrative Questionnaire for Due Diligence of Hedge Fund Administrators* (available to AIMA members and institutional investors only).
10 - SAS 70 / AAF01/06 reports are produced by Auditors, in accordance with the relevant auditing standards, in order to report on a service organisation's controls environment. Such reports allow an organisation that provides third party services to disclose their control activities and processes to their clients and their clients' Auditors in a uniform reporting format.

Recommendations on Governance

It is sometimes argued that Valuation Service Providers have a conflict of interest because they usually receive remuneration in the form of a percentage of a Fund's assets under management. This is true to the extent that a growth in assets through performance will feed through to their fee income, but it is important to stress that the vast majority of Valuation Service Providers follow sound practice by not receiving any remuneration directly linked to performance. However, the Governing Body should be alert to other threats to a Valuation Service Provider's independence. For example, a Valuation Service Provider may be reliant on funds managed by one Investment Manager for the majority of its income. This is a factor to be considered along with any other conflicts of interest caused by the nature of the Investment Manager's relationship with the Valuation Service Provider. If the Investment Manager is a shareholder in a Valuation Service Provider, or if the two organisations share personnel, the independence of the Valuation Service Provider will clearly be compromised.

Once the Valuation Service Provider has been selected, the precise details of its terms of engagement will be agreed, and are often enshrined in a Service Level Agreement. Another benefit of producing a Valuation Policy Document is that this can be included as part of the Service Level Agreement.

After the Fund is launched, the Governing Body should periodically refresh its due diligence on the Valuation Service Provider. It may also ask the Provider to report to it in person, especially if questions have been raised by the Investment Manager or Auditor. It is also the ultimate responsibility of the Governing Body to ensure that the Service Level Agreement between the Fund and the Valuation Service Provider is kept up to date.

Self-administration by the Investment Manager

As noted in the Overview, for some Funds with hard-to-value securities in their portfolios, it may be concluded that the Investment Manager is best placed to provide the most accurate and timely valuation of the portfolio. The Valuation Service Provider in these instances will either be an entity affiliated with the Investment Manager or the back office of the Manager itself.

Where these arrangements exist the Governing Body should periodically satisfy itself that it continues to be in the Fund's best interests for valuations to be produced by the Investment Manager. The Governing Body should also ensure that written procedures, segregation of duties and proper oversight are all in place. It should insist upon a Valuation Policy Document which specifies the methods and sources the Investment Manager uses, and which if possible names the personnel at the Investment Manager who will be responsible for valuation. The Governing Body may wish to have these staff report directly to them on a periodic basis.

In some partnership structures where the Investment Manager is the General Partner (and therefore the Governing Body),

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measures should be taken to address potential conflicts of interest in the sphere of governance. Some Investment Managers who are General Partners establish a Valuation Committee which acts as a *de facto* Governing Body on matters relating to valuation. It is clearly preferable that this Committee should include as many members as possible who are independent of the Investment Manager, although it is recognised that it may be difficult to source suitably competent members who are available at each month-end. At the very least, a majority of the Committee should be comprised of non-executives and/or staff of the General Partner who do not report to those involved in investment decisions. It is sound practice for staff from compliance and risk management functions to be represented on the Committee. It is also preferable that staff of the General Partner who sit on the Committee are not remunerated directly on the basis of Fund performance.

A Fund's Auditor may be engaged to perform attestation work each month or quarter and to produce a report to provide some level of extra check for the Governing Body and investors upon valuations performed by the Investment Manager. These exercises are a useful tool of governance when self-administration takes place, but they should not be relied upon in isolation.

Controls to manage potential conflicts of interest and to ensure segregation of duties are discussed further under Recommendations 8 and 9.

✔ A Governing Body, along with the Investment Manager, visits a shortlist of independent Valuation Service Providers. After due consideration, the Governing Body appoints one of the candidates on the basis of criteria such as the competence of its staff and its experience of valuing the instruments which the Fund will trade.

✖ A General Partner establishes an internal Valuation Committee where the lead portfolio manager has an arbitrary power of veto over the valuation of any instrument in the portfolio without reference to parameters laid down by a Valuation Policy Document.

Escalation Procedures

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.

To fulfil its responsibilities in this area the Governing Body should ensure that the Valuation Policy Document of the Fund allows it to review any positions where the Investment Manager has material input into the valuation of a position or where the Investment Manager wishes to override the price provided by the Valuation Service Provider.

In practice, escalation to Governing Body level will tend to arise in two cases. Firstly, there will be positions where it is accepted that the Investment Manager will effectively be the primary source of the

Recommendations on Governance

valuation (for example, a position in the convertible debt of a private company, where the Investment Manager may have better insight into expected future cash-flows than any other stakeholder in the valuation process). Secondly, and probably more rarely, there may be instances where the Investment Manager and Valuation Service Provider have a genuine disagreement about which price source or model inputs should be used.

In the first case, where documented procedures will be important, the Governing Body may chose to delegate monthly review of the valuation of the specific instruments to a Valuation Committee or to a suitably qualified member of the Governing Body who is independent of the Investment Manager and the Valuation Service Provider. In addition, the Governing Body may perform a periodic review to ensure that the Investment Manager's involvement is required and that the assumptions behind its input are reasonable.

In the second case there should be a clearly defined escalation procedure in the Valuation Policy Document. The Governing Body should receive representations from the various parties involved in order to reach a decision on the fairest price to be used. In these circumstances, the "burden of proof" for an override should lie with the Investment Manager not the Valuation Service Provider. The reasons for the final decision of the Governing Body should be documented.

✔ A Fund establishes in its Valuation Policy Document a clear protocol for the handling of overrides requested by the Investment Manager. This includes guidance as to the kind of evidence considered substantive by the Valuation Committee, as well as a reminder that the Committee is quorate only when a majority of members present are independent of the Investment Manager.

✖ For a Fund where the back office acts as *de facto* Valuation Service Provider, a number of its prices are overridden by the front-office team. The back office re-runs the NAV report without any formal review by the Governing Body or Valuation Committee. No documentation supporting the rationale for the front office's overrides is maintained.

Recommendations on Transparency

Recommendations on Transparency

Offering Document Disclosures

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.

As noted under Recommendation 1, the Offering Document of the Fund contains formal disclosures on which basis investors subscribe to the Fund. It is normal practice for the Offering Document to include a section on "Valuation" or "Net Asset Value". By convention, disclosures made under this heading will include details of the frequency of the production of the NAV, headline valuation policies to be applied to each major category of assets/liabilities and disclosures about risks inherent in the valuation process.

It is understandable that some of these disclosures in the Offering Document are generic in nature, whereas the detailed policies and procedures would be found in a Valuation Policy Document. For example, Offering Documents often include a statement that the Fund's valuation policies may be altered or overridden "at the discretion" of the Governing Body or Investment Manager without such discretion being precisely defined.

However, whatever the level of detail in the Valuation Policy Document and the Fund's policy relating to its disclosure, investors may reasonably expect to receive meaningful information in the Offering Document over and above boilerplate language. In particular, it is sound practice for the identity of the Valuation Service Provider (whether independent of the Investment Manager or not) to be made completely unambiguous.

Other disclosures in an Offering Document to help investors better understand the valuation process might include:

1. Clear disclosure of who has oversight responsibility for the valuation of the Fund's assets and liabilities (this would include explanation of the role of the Valuation Committee if there is one).
2. If the Investment Manager is likely to have material involvement in the valuation of the portfolio, disclosure of that fact (see also Recommendation 6 below).
3. Some guidance as to how fair value will be ascertained in practice, if the Fund has non-exchange-traded positions.
4. Detailed disclosure of policies relating to side pockets, should they be allowed for by the Offering Document.

✔ A Fund makes explicit disclosure in its Offering Document that the Investment Manager is delegated responsibility for determining the NAV and that the Administrator acts merely as a Registrar.

✖ A Fund where a division of the Investment Manager acts as Valuation Service Provider makes no disclosure about the determination of NAV in its Offering Document, other than the potentially misleading statement that the NAV is "disseminated at each month-end by the Administrator".

Recommendations on Transparency

Disclosure of Investment Manager Involvement

6 - There should be adequate disclosure of any material involvement by the Investment Manager in the pricing of underlying portfolio positions.

When an independent Valuation Service Provider is delegated overall responsibility for the determination of a Fund's NAV, investors still have the right to expect disclosure of any material involvement by the Investment Manager in the process. The definition of materiality in this context should be strict. Disclosures do not have to take the form of a prescriptive "health warning" about the level of valuation risk in the Fund, but sufficient information should be disclosed to investors for them to be able to draw their own conclusions and make appropriate decisions.

The most straightforward way for disclosure to be made is the release, on a confidential basis, of the Fund's Valuation Policy Document. If potential investors are provided with the Document during their due diligence process, they may then follow up with questions to the Investment Manager and/or Valuation Service Provider about the typical percentages of NAV represented by each main category of instrument. Existing investors might reasonably expect such disclosure to be repeated annually at their request, or whenever the percentage of NAV in which the Investment Manager has involvement changes materially.

The process transparency granted by such disclosure is not the same thing as portfolio transparency, about which the Investment Manager may have genuine concerns. But if, for whatever reason, the Investment Manager and / or Valuation Service Provider do not wish the Valuation Policy Document to be available to investors, the expected "bandwidth" of NAV where the Investment Manager might be involved should still be disclosed.

It is also sound practice for the Fund's audited financial statements to contain a note outlining the percentages of NAV as at the balance sheet date which are valued by the Investment Manager, disclosing the methods used and the nature of the Manager's involvement.[11]

✔ A Governing Body, in consultation with the Investment Manager, authorises disclosure of the Fund's Valuation Policy Document to investors and potential investors.

✖ An Investment Manager has material involvement in the pricing of hard-to-value investments in a Fund's portfolio, typically representing 10-15% of the Fund's net assets. This fact is not recorded in any documentation received by investors and not voluntarily disclosed during any investor's due diligence process.

11 - For year-ends from late 2007 onwards, financial statements prepared under US GAAP must include a disclosure note outlining the percentage of net assets in each of the three levels defined by FAS 157 (see Appendix 4 for further details).

Recommendations on Transparency

In 2000, the Investor Risk Committee of the International Association of Financial Engineers proposed that there were four "dimensions" in which information provided by hedge fund managers should be evaluated.[12] The AIMA working party has used these headings - content, granularity, frequency and delay – to organise some typical questions about transparency pertaining to the hedge fund valuation process specifically:

IRC framework applied to the valuation process	
Content	**What is the quality and sufficiency of coverage in the information disclosed about the valuation of the Fund?** • Does the disclosure include a clear outline of the responsibilities of each stakeholder? • Are price sources for each instrument type disclosed to investors as well as accounting policies? • Is the cut-off time for formal valuation of the portfolio disclosed?
Granularity	**What is the level of detail of disclosure?** • Are Fund stakeholders prepared to disclose or discuss the valuation of every position in the portfolio? • Do Fund stakeholders prefer to disclose percentage bandwidths for pricing sources used? • Are Fund stakeholders prepared to disclose the precise number of overrides by the Investment Manager accepted by the Governing Body in a given period?
Frequency	**How often is disclosure made?** • For positions valued according to a model designed by a third party or Investment Manager, how often should investors be updated about the model's assumptions? • How frequently should hedge funds allow investors access to question those responsible for its valuation process?
Delay	**How much of a time lag is there between the occurrence and the disclosure of events in the valuation process?** • If there has been a material change in the valuation policy of a Fund, how long is it before investors are informed? • If Fund stakeholders provide detailed disclosure of how the portfolio is valued on a delayed basis, what degree of delay is acceptable for the information to be meaningful? • Is it reasonable to expect investors to rely on audited financial statements only for information on the percentage of hard-to-value instruments in the portfolio?

12 - *Findings on Disclosure for institutional investors in Hedge Funds (2000).*The IRC is part of the International Association of Financial Engineers (www.iafe.org).

Recommendations on Transparency

NAV Reporting

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.

Offering Documents usually give an indication as to the frequency of NAV reporting, which will be at least as frequent as dealing days. Typically, a formal NAV will be calculated at each month-end. Administrators are usually bound by their Service Level Agreement with the Fund to produce and disseminate the NAV within an agreed timescale after month-end. Increasingly, Administrators are developing web-based reporting infrastructures that can be directly accessed by investors.

There should be as little scope as possible for the manipulation of a Fund's NAV once the formal NAV process has been completed. When the Administrator is also the Valuation Service Provider of the Fund, it should be the party which disseminates the month-end NAV. When a division of the Investment Manager is the Valuation Service Provider, there should be controls in place to ensure that the NAV cannot be amended by unauthorised personnel once it has been finalised.

Investment Managers may wish to give investors an idea of performance before the completion of the formal NAV process. In such cases, preliminary indicative estimates may be sent directly to investors by the Investment Manager prior to the final formal NAV statement for the period, as long as suitable disclosures are made. There should be no room for confusion between these "flash" estimates and the formal NAV on which the Fund is traded.

✔ Because of the requirements of its investors, an Investment Manager undertakes to provide a month-end estimate for a Fund. These estimates are accompanied by clear disclosures that they are based on the Investment Manager's own unverified price sources and that the official NAV will be produced and disseminated by the independent Valuation Service Provider at a later date.

✖ An Administrator who acts as Valuation Service Provider completes its production of a Fund's month-end NAV and then sends an NAV spreadsheet to the Investment Manager on the grounds that the Manager is best placed to distribute it to the most relevant investor contacts. The Investment Manager then reserves the right to amend the NAV before sending it to investors.

Recommendations on Procedures, Processes & Systems

Recommendations on Procedures, Processes & Systems

Segregation of Duties

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.

At the Investment Manager, clear segregation of duties between those responsible for investment decisions and trading (front office) and those responsible for trade settlement, portfolio reconciliations and accounting (back office) should be a control in place for a number of operational reasons. As already stated, these controls become all the more important when the back office of the Investment Manager is in effect the Valuation Service Provider. There should be a dedicated team responsible for valuation which has no involvement in any investment process. Team members should be the only members of staff authorised to input prices directly into the Manager's portfolio accounting system. In the normal course of business, they should also be responsible for sourcing quotations from brokers and counterparties, and for inputting data into pricing models if they are used. The Fund's Valuation Policy Document should make clear the circumstances in which the front office may become involved in the process. An emphasis on segregation of duties does not imply that front-office professionals at the Investment Manager will never be consulted about valuation issues. It is also entirely sensible for them to review an NAV calculation before its release to investors, as long as any objections they raise are made through the proper channel such as a Valuation Committee.

As discussed under Recommendation 3, the usual way in which a Governing Body will achieve segregation of duties in the valuation process is to delegate the determination of the Fund's NAV to an independent Valuation Service Provider, with clear procedures enshrined in a Valuation Policy Document. The precise way in which the Valuation Service Provider verifies instrument prices will vary from Fund to Fund. For each position in the portfolio, the Valuation Service Provider will usually be responsible for supplying prices from at least one of the sources listed in the Valuation Policy Document, so that it can check the variance with the other sources. The crucial point is that the Valuation Service Provider should control the process of reconciling price sources with no unsolicited interference from the Investment Manager. A Prime Broker acts as custodian of the Fund's assets; an independent Valuation Service Provider might be described as custodian of the asset valuation process. Formal intervention by the Investment Manager in the NAV reconciliation process should not be permitted but, after its own review of the Valuation Service Provider's NAV calculation, the Investment Manager may request a price override following the procedure outlined under Recommendation 4.

Recommendations on Procedures, Processes & Systems

✔ Acting as Valuation Service Provider for a Fund, a dedicated back-office team is responsible for sourcing or modelling all prices and entering them into the Investment Manager's portfolio accounting system. No members of the front office are allowed involvement in the process unless, in accordance with the Valuation Policy Document, either the back office ask them to help procure a specific quotation from a broker or they are making a formal deposition to the Valuation Committee in relation to a complex or illiquid instrument.

✖ For the production of a Fund's month-end NAV, the Investment Manager e-mails the independent Valuation Service Provider a portfolio valuation. The Valuation Service Provider spot-checks this valuation but uses it as the basis for the formal NAV calculation without sourcing or modelling prices independently.

Supporting Information

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.

The typical categories where it may be accepted by the Governing Body that the Investment Manager will be the primary source for the valuation of a particular instrument are as follows:

1. Thinly traded instruments where exchange-traded prices may be non-existent or unreliable
2. Complex Over-the-Counter (OTC) Derivatives
3. Private equity or quasi-private equity positions

For the first category, the Investment Manager may furnish the Valuation Service Provider with broker quotations (see Recommendation 13) or a report on recent trading activity which provides evidence for its view of fair value. For OTCs, the Investment Manager will usually be able to provide supporting details of its own model-based calculations (see Recommendation 14).

The need for supporting evidence can be more pronounced for positions where a Fund has provided finance to a private company in return for debt or equity. An Investment Manager may illustrate its view of the current fair valuation with peer-group revenue multiple models, reports on recent liquidity events for similar positions, discounted cash-flow models, or a weighted combination of those approaches. Such tools, common in private equity valuation, are based on sound economic principles. However, many of the parameters used in such models are subjective, and the resulting valuation can vary widely depending upon a particular investor's perspective of the current market risk premia and the probability distribution of future cash-flow estimates.

If the Fund is expected to invest in private positions on a regular basis, the Valuation

Recommendations on Procedures, Processes & Systems

Practical Implementation

Policy Document may enshrine a procedure such as discussion of each investment at a monthly Valuation Committee meeting. The minutes of this meeting would be provided to the Valuation Service Provider as supporting evidence for current fair value. Such a procedure may be backed up by a periodic written report from an independent pricing specialist.

If there is inadequate documentary support for an Investment Manager's valuation which the Valuation Service Provider cannot validate by other means, the matter should be escalated to Governing Body level.

✔ A Fund's Valuation Policy Document clearly specifies two price sources for each instrument type, and confers responsibility for verifying the sources to the Valuation Service Provider. Because the great majority of instruments in the Fund's portfolio are exchange-traded, sourcing is not expected to be complex. If any price is provided by the Investment Manager for any instrument this is an automatic matter for escalation to Valuation Committee level where the Manager will be expected to provide supporting documentation to the satisfaction of the Committee.

✖ For a number of private positions, the Investment Manager provides the Valuation Service Provider with a scribbled fax giving nothing more than its recommended valuation, without any supporting documentation. The Valuation Service Provider accepts these prices despite the Valuation Policy Document clearly outlining the required standards of documentation for private investments.

10 - Procedures described in the Valuation Policy Document of the Fund must be capable of practical implementation by the Valuation Service Provider.

Before a Valuation Service Provider accepts the Fund as a contracting party, it must ensure that it can implement the valuation policies as described and that its systems can access and process the pricing sources and models to be used for each instrument type. Sufficient time should be given to Valuation Service Providers to undertake the necessary due diligence when the other Fund stakeholders are unknown to them. They should be consulted about the draft Valuation Policy Document as early as possible during the inception of the Fund (a minimum of several weeks prior to launch) and the Document should ideally be finalised before launch of the Fund.

The Valuation Service Provider may facilitate the preparation of the Valuation Policy Document by issuing standard valuation procedures which the Governing Body, in consultation with the Investment Manager, may accept are appropriate for the Fund after due consideration. For more complex portfolios, procedures over and above the standard will be agreed.

All stakeholders should be comfortable before launch that the procedures enshrined in the Valuation Policy Document are realistic and

Recommendations on Procedures, Processes & Systems

can be carried out by the designated party in practice. It may, for example, be assumed that a Valuation Service Provider can source two broker quotations for distressed debt positions by itself. If this is not in fact the case and ongoing involvement from the Investment Manager is required to encourage the brokers to co-operate, it is better to enshrine a workable but robust procedure into the Valuation Document (such as the copying of e-mails to the Valuation Service Provider) rather than insisting on a more rigid policy which means that in practice virtually every position priced off broker quotations would have to be escalated for review by the Governing Body.

Consistency of Application

One important issue for the Valuation Service Provider (whether it is independent of the Investment Manager or not) is the competence of staff detailed to the valuation process. If complex instruments types are to be added to the Fund's investment mandate, the Valuation Service Provider should ensure that sufficient training has been given to staff assigned to work on those instrument types. The Governing Body should monitor the adequacy of staff training in its ongoing reviews of the Valuation Service Provider. If the Valuation Service Provider is effectively the back office of an Investment Manager, the firm's compliance function may perform such a monitoring role as part of its general oversight of staff training and competence.

✔ As part of the set-up process of a Fund, the Governing Body circulates a draft Valuation Policy Document to the Investment Manager, the Valuation Service Provider and the Auditor. All parties are given time to make representations as appropriate and the Document is suitably revised before the launch of the Fund.

✖ An Investment Manager intends to launch a new Fund because it has decided to begin trading a new complex strategy in as rapid a timeframe as possible. Details of the proposed valuation policies reach the Valuation Service Provider a mere forty-eight hours prior to the launch of the Fund. The Valuation Service Provider is persuaded to accept the engagement before it is satisfied it can implement procedures outlined in the draft Valuation Policy Document.

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.

A crucial component of the Valuation Service Provider's processes will be to check that the price sources for each instrument type as outlined in the Valuation Policy Document are being consistently applied (see Recommendation 12). The Valuation Service Provider may also conduct further checks on the consistency of valuation, using the following tools:

1. A stale price report which highlights any instrument where the price has remained the same month-on-month. The instruments on this list would then be investigated further to ensure that the price is not out-of-date and that the valuation is appropriate.

Recommendations on Procedures, Processes & Systems

2. A large variances report which highlights any variances over a set percentage from the previous month-end NAV. Again, the instruments on this list would then be investigated to ensure that the large price movements month-on-month were genuine.
3. Valuation Service Providers may also be able to run a report listing instrument prices from sources other than those listed in a Fund's Valuation Policy Document which can highlight any material variances between the average of all sources.

There should only be rare instances where a Valuation Service Provider decides not to apply a pricing policy enshrined in the Valuation Policy Document. For example, the Document may state that the bid/ask spread of an instrument should be obtained and the midpoint used for valuation, but in practice only the bid price may be available. Even if the Valuation Service Provider and the Investment Manager agree that a deviation from the usual policy is acceptable, this fact should ideally be escalated to the Governing Body for approval.

Circumstances may also arise where new instruments are created and therefore do not yet have an official policy incorporating them. In the case of new instrument types, the Governing Body should formulate a written policy as soon as practicable. Some Valuation Service Providers have internal procedures which do not allow them to accept a deviation from the documented policy without receiving a written resolution from the Governing Body.

✔ A Fund's Valuation Policy Document names a specialist vendor as the primary source for bank debt. One month-end the vendor cannot furnish a price for a particular position. In consultation with the Investment Manager, the Valuation Service Provider finds another specialist vendor who can provide a valuation. The matter is put on the agenda for the Fund's monthly Valuation Committee meeting and the price from the alternative source is approved for inclusion in the month-end NAV.

✖ Although the Valuation Policy Document gives it no such authority, an Investment Manager seeks to have full discretion over the level of a liquidity discount factor each month, without any reference to the Governing Body or Valuation Service Provider.

Recommendations on Sources, Models & Methodology

Recommendations on Sources, Models & Methodology

Multiple Sources

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.

For exchange-traded instruments, prices tend to be sourced from recognised vendors of market information. Most Investment Managers and Valuation Service Providers have direct feeds from one or more of these vendors. The principle of checking each position against at least two price sources is advisable, even for instruments which are normally easy-to-value. There is clearly more chance of picking up a one-off error caused by a faulty input or feed (mistakes sometimes euphemistically referred to in the industry as "data exceptions") if there is another source against which to check the primary source. Given the number of data vendors, the valuation of exchange-traded instruments should not be based on only one price source.

It is in fact sound practice for a second pricing source to be sought for all positions in a portfolio. For instance, the valuation of an OTC derivative will often be derived from a pricing model, but the counterparty's valuation can be employed as a secondary source. In another example, the Governing Body may approve the outsourcing of mortgage-backed securities valuation to a pricing specialist, but the Investment Manager's own marks will still be used as a reasonableness check. In the course of the work they perform for their range of clients, Valuation Service Providers may also receive prices for certain instruments drawn from various other sources such as counterparty statements, broker quotations, feeds from data aggregators and reports from pricing specialists. One or more of these may be cited in a Fund's Valuation Policy Document as secondary sources. It may of course prove impossible to find a reliable second price source. An example would be a private position where the Investment Manager is the only party competent to produce a best estimate of fair value. If such positions form a material part of a Fund's NAV, suitable disclosures should be made following our transparency recommendations.

Depending on the type of instrument being priced, the Governing Body of a Fund, in consultation with the Valuation Service Provider and Investment Manager, can define in the Fund's Valuation Policy Document the hierarchy of price sources to be used, with appropriate tolerance levels if there is a discrepancy between the primary and secondary source. The tolerance levels used may depend upon the instrument type, but variances will normally be measured both in terms of the percentage difference between the sources and the basis points impact on overall Fund NAV. Some Valuation Policy Documents also specify a dollar amount over which any variance should be escalated for the Governing Body's review.

Recommendations on Sources, Models & Methodology

✔ A Fund's Valuation Policy Document states that, for all exchange-traded securities, the price from a defined primary market vendor source should be used, unless the price from a defined secondary source gives a variance over a set tolerance level. The Valuation Policy Document also outlines an escalation process for the resolution of any material variances.

✖ Because of time pressure a Valuation Service Provider bases portfolio valuations on a single source (a Prime Broker's report, despite the disclaimers provided by the Prime Broker). The Valuation Service Provider performs no further verification work.

Broker Quotations

13 - If the Governing Body approves the use of broker quotations for the valuation of certain instruments, all reasonable efforts should be made to ensure that these quotations are multiple, sourced consistently and accessed by the Valuation Service Provider independently without intervention by the Investment Manager.

For thinly traded or illiquid securities, especially convertible bonds, distressed and high-yield debt, quotations from market-makers (usually brokers) may sometimes be deemed the sources most fully reflective of fair value.

The main issues when broker quotations are used are to ensure as much independence from the Investment Manager as possible in sourcing the quotations and to ensure that the quotations provided are the most accurate and relevant.

The Governing Body of a Fund may therefore establish a policy in the Valuation Policy Document stating that, if a valuation for a security cannot be sourced from either of the Fund's chosen market data feeds, or if a Valuation Committee agrees that market data is unreliable given the size of the Fund's position or the low frequency of trading, broker quotations may be used as a primary source.

The minimum number of quotations required and the method of calculating an average price may depend on the nature of the instruments. In some cases, a simple mean of the quotations received is calculated; another procedure, if five or more quotations are available, is to discard the outliers and then to calculate an average (of ask, bid or mid price as stipulated in the Valuation Policy Document).

When broker sources are used, the Valuation Service Provider should procure month-end quotations directly from those sources. In practice, some of the larger Valuation Service Providers receive multiple quotations in the course of other NAV exercises, and log them onto a database or other system. It is recognised that in certain circumstances the Valuation Service Provider lacks sufficient leverage over the broker to ensure a quotation is sent directly. In these cases it is sometimes possible for the Valuation Service Provider to be copied in

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directly on e-mail correspondence so that it does not have to rely on information forwarded by the Investment Manager. Some third party vendors also provide services aggregating market-maker quotations for asset classes such as bank debt.

In normal circumstances, quotations from the same brokers should be used at each month-end to ensure consistency in the valuation of the relevant instruments. It is not sound practice, in cases where it has been customary for two or three brokers to provide the month-end quotations for a particular instrument, for another source to be suddenly substituted without proper explanation and consultation. The Investment Manager may have entirely legitimate reasons for recommending that a certain broker should be used because it has started to cover a particular instrument, or that a particular quotation should be discarded because the broker in question has been providing spreads which would change materially if the Fund actually attempted to trade. These reasons should be documented to the satisfaction of the Governing Body as a control against possible "cherry-picking" of broker sources by the Investment Manager.

It is also important to ensure that the quotations received are not merely indicative but are meaningful in the context of the Fund's total holding in an instrument. The Investment Manager is usually best placed to have an opinion if a quotation from a market-maker is unrealistic for a transaction of any volume. However, the Governing Body, as part of its ongoing monitoring of valuation procedures, may wish to receive a periodic report comparing prices achieved on the sale of thinly traded instruments with their most recent formal valuations before sale if derived from broker quotations.

✔ A Fund's Valuation Policy Document states that convertible bonds for which no reliable market data exists will be priced at the mean of three named broker quotations. Any change to the named brokers must be approved in writing by the Governing Body, and the Valuation Service Provider will make best endeavours to source the quotations directly.

✖ Members of the Investment Manager's front office enter into a Fund's portfolio accounting system valuations for a number of high-yield bonds on the basis of the broker quotation they feel "best reflects" the fair value of the securities. The back office, acting as Valuation Service Provider, has no transparency for the quotations used and no way of ascertaining whether they are from consistent sources.

Pricing Models

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.

For derivatives traded over-the-counter between two counterparties, the absence of

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a secondary market means that the standard method of valuation will be a pricing model. Models may also be used as a primary source for complex derivatives or instruments with an element of optionality where other sources are considered unreliable.

Pricing models are becoming more complex and may require a significant level of back-testing and independent verification prior to being used as a valuation tool. In some instances, a pricing model may have been designed to value a certain type of financial asset, and over time may be modified to incorporate more exotic types of financial instruments, causing possible weaknesses and workarounds.

The Fund's Governing Body, as part of its oversight of the entire valuation process, should approve any decision to use a pricing model as a formal valuation source for any part of the portfolio. Such oversight is particularly important if the model used has been developed by the Investment Manager, or if the model will be used as a primary source in preference to a quotation on a recognised exchange. The Governing Body will typically seek representations from the Investment Manager and/or vendor of the model, as well as the Valuation Service Provider if the Valuation Service Provider will be using the model for production of the month-end NAV. The Governing Body may seek the opinion of an independent expert – it is sound practice for them to do so if the model has been developed internally by the Investment Manager and is material to the NAV. In any event, documentation of the approval process may include:

1. The reasons for using a pricing model rather than a market price (typically because of the unavailability or inaccuracy of an exchange-traded mark).
2. The reasons for the choice of a particular pricing model as opposed to alternative models (typically with a review of the advantages and disadvantages of the models under consideration).
3. An appraisal of the strengths and weaknesses of the pricing model used, and its consistency with the Fund's established valuation policies. If the pricing model in question is an "off-the-shelf" solution from a model vendor, references from reliable third parties may be procured. If the model has been internally developed by the Investment Manager, an independent expert may report its findings.
4. Defined procedures outlining who will be responsible for inputting data to the model and guidelines for the method of calculation (especially if there is any subjective element to the interpretation of the data or the method of calculation).
5. An escalation process should the valuations produced by the model fall out of a prescribed tolerance range when compared to an alternative pricing source such as a counterparty quotation.

Although there may not always be complete consensus as to whether a pricing model is "industry standard", the Governing Body may note that stakeholders such as the Investment Manager, Prime Broker and

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Valuation Service Provider are comfortable with the model in question. In practice, the more straightforward OTC contracts would include interest rate swaps, equity swaps, foreign exchange options and many credit default swaps. For these instruments, pricing models with readily available data-input parameters are routinely used by market counterparties.

More complex OTCs include long-dated out-of-the money swaptions, long-dated equity index options, some variance swaps, credit default swap options, synthetic collateralised debt obligations and mortgage-backed derivatives. Valuation models exist for these types of instrument but the assumptions and data inputs used are likely to involve subjective judgement. In certain circumstances, it may be agreed that counterparty quotations will be used as a primary source, although every effort should be made to approve a model as the primary source.

Once a model has been adopted by a Fund, its outputs should be monitored against other sources. The most obvious of these is the counterparty mark, but it is also useful to compare the realised proceeds once a derivative contract is unwound to a contemporaneous valuation by the model if this has been recorded. The Investment Manager and Valuation Service Provider may also have access to other models for the same type of derivative.

✔ Before the launch of a Fund, the Governing Body reviews pricing models for complex variance swaps. It decides, after consultation with the Investment Manager and the Valuation Service Provider, that the preferred model is currently not reliable enough to be used as a primary source. It is therefore stated in the Valuation Policy Document that the model will be a source secondary to a counterparty quotation until such time as the Governing Body approves it as a primary source.

✖ On the grounds of immateriality, a Governing Body allows an over-the-counter derivative not previously traded by the Fund to be valued according to a pricing model developed by the Investment Manager. However it then fails to approve the pricing model formally, so that the model continues to be used on a month-to-month basis without proper scrutiny by the Governing Body and without the Valuation Policy Document being updated to take account of the new derivative product.

Side Pockets

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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The fact that investors in a hedge fund regularly subscribe and redeem on the basis of a formal NAV means that the cost accounting methods typically used by private equity funds are not necessarily appropriate for material holdings in private or quasi-private investments. On the one hand, a policy which does not revalue a private position upwards from cost (until a tangible event) protects investors from the possibility that valuations where subjective judgement is required may be unintentionally or deliberately overstated. On the other hand, if there is no attempt to fair-value a private investment for a prolonged period, investors who redeem from the Fund in the interim will not be treated fairly.

A method of dealing with the issue of long-term illiquidity which is becoming increasingly prevalent in the industry is the use of "side-pocket" share classes, sometimes known as Special Situations or Class S shares.

Under side-pocket methodology, financial assets that are removed from the valuation process applied to the rest of the portfolio are held either at cost or at estimated fair value (depending on the Fund's valuation policy for the side pocket) until either a liquidation, a flotation, a third party sale or some other event which points to clear evidence of current fair value.

There are a number of variations in side-pocket methodologies but the usual practice of hedge funds is that only those investors who hold a position in a Fund at the time that the transaction was designated for a side pocket are permitted to participate in the subsequent gain or loss when the position is eventually realised. Investors hold a separate class of shares for each side-pocket transaction, which can be redeemed only when realisation has occurred. Investment Managers do not usually receive a performance fee on the side-pocket share classes until this moment of "crystallisation". In some hedge funds, participation in side pockets is mandatory; others allow investors to opt out of side pockets; others give investors the opportunity to decide whether to participate on a case-by-case basis.

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Arguments for and against side pockets

Advantages	Disadvantages
1. The nature of side-pocketed positions is that their returns tend to be "j-curved", even when they are fair-valued on a periodic basis. In other words, a catalyst or exit route is usually required for the value embedded in the position to be realised. The side-pocketing of these positions at inception ensures that current investors in the Fund are not diluted by later investors who may gain exposure to the position at a conservative valuation that does not necessarily represent fair value. 2. By side-pocketing very illiquid positions, the Investment Manager can still offer their investors exposure to interesting long-term ideas without compromising the "headline" liquidity of the Fund itself. 3. The valuation issue for a private position, where some kind of model will probably be used and subjective judgement will be required, will largely fall away if the position is ring-fenced from the rest of the portfolio and no performance fee is charged until the position is realised. (Of course the Investment Manager and other stakeholders will continue to fair-value the position informally).	1. There may be an economic or psychological motivation for Investment Managers to recommend the side-pocketing of positions not solely on the grounds of illiquidity or the complexity of valuation, but because the Manager thinks the risk may be on the downside and prefers not to have the position included in the main Fund's reported performance and volatility. 2. Especially if the positions are immaterial, the administration of the side-pocket share classes can be unjustifiably burdensome for the Administrator, Investment Manager and investors alike. 3. Certain categories of investors find side pockets very hard to accommodate in portfolios because of their indeterminate duration. The investment mandates of these investors may proscribe holdings in underlying funds which have worse than quarterly liquidity, but side pockets may take years to liquidate. 4. All these disadvantages are exacerbated if side-pocket participation is mandatory.

The introduction of side-pocket provisions into a Fund's constitution is a material change and should be given very careful consideration. A Governing Body should weigh up the advantages and disadvantages of side pockets, in the context of its particular Fund, and may wish to consult investors as well as the Investment Manager and the Valuation Service Provider. If it is decided that side-pocket classes are to be a feature of the Fund, the mechanisms surrounding them should be clearly disclosed in the Fund's Offering Document (as mentioned under Recommendation 5). The Governing Body

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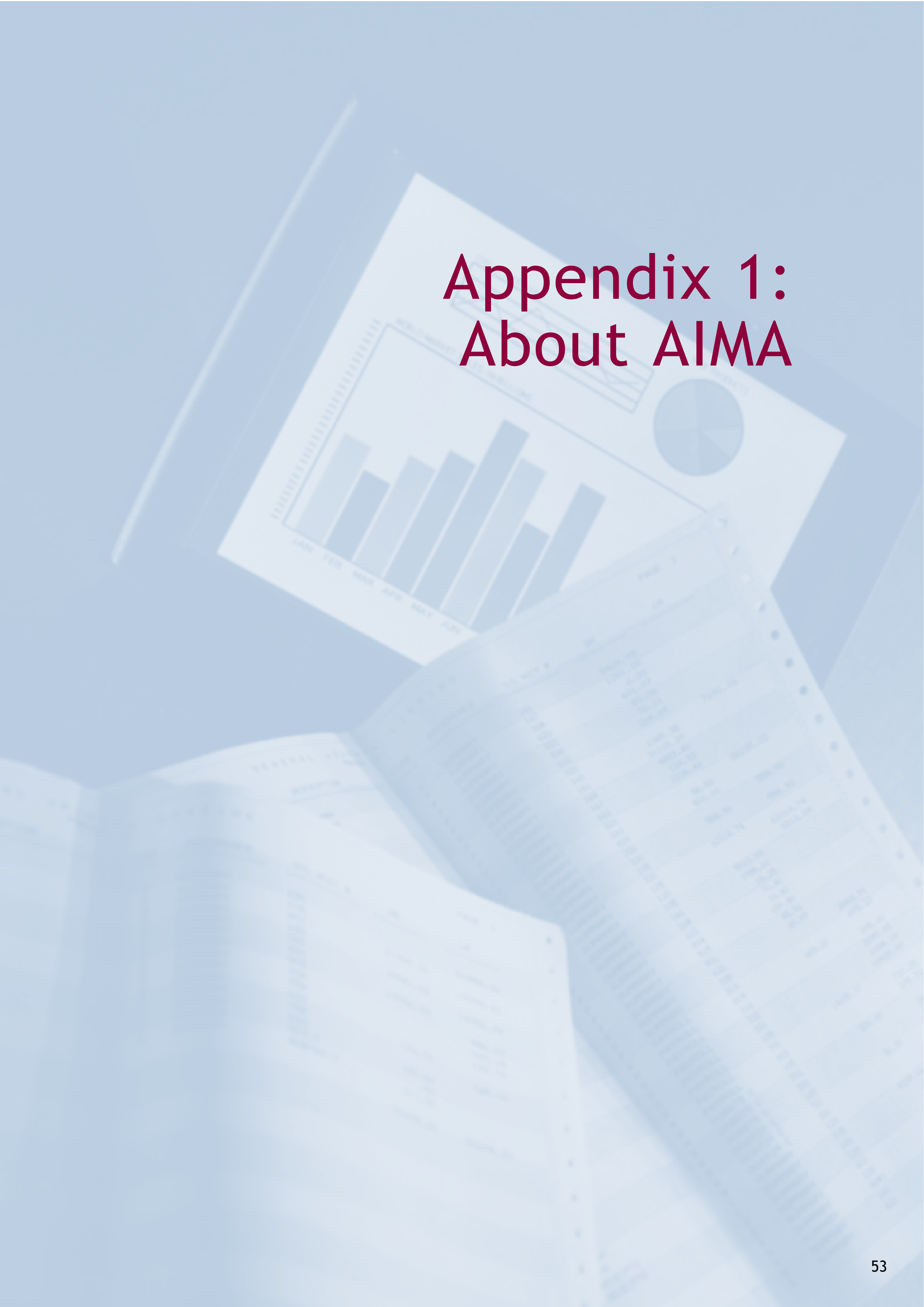
should also have formulated and disclosed its policies on opt-outs, fee-charging arrangements and the maximum percentage of Fund net assets allowed in side pockets.

It is difficult to propose prescriptive rules for each specific decision to side-pocket an investment, because subjective judgement will always be required. However, the Governing Body should aim for as much consistency as possible in its criteria for side-pocketing and should require the Investment Manager to justify any request to side-pocket a position. Factors to be considered will include the materiality of the position, the fair value measurements available, the likely time horizon to realisation of the investment and the nature of exit strategies. Particular scrutiny should be given to proposals to side-pocket a position which is already in the Fund's portfolio.

✔ A Governing Body, after consultation with the Investment Manager, notes that the number of private or quasi-private positions in the portfolio is likely to be immaterial in the context of the Fund overall. It also takes steps to ensure that the Valuation Policy Document contains details of the fair value methods, or combination of methods, which may be used to price such positions. It therefore concludes that side-pocket classes will not be required, reserving the right to review the situation if the number of private positions increases or if fair value models prove consistently unreliable.

✖ For a Fund with existing side-pocket provisions the Governing Body accepts an Investment Manager's request to side-pocket an exchange-traded position (which has already been in the portfolio for some time) on the grounds of "general illiquidity".



Appendix 1: About AIMA

About AIMA

The Alternative Investment Management Association (AIMA) is the not-for-profit global hedge fund association with over 1,100 corporate members in 47 countries.

Members include leading hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting service providers and fund administrators. They benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals and its excellent reputation with regulators, worldwide.

AIMA is a dynamic organisation that reflects its membership's interests and provides them with a vibrant global network.

Key projects created and distributed by AIMA include:

- Series of illustrative due diligence questionnaires for the selection of managers and service providers (available to AIMA members and institutional investors)
- Guides to Sound Practices for European, Canadian and Asian Managers
- Guide to Sound Practices for Hedge Fund Administrators
- Offshore Alternative Fund Directors' Guide

Additionally, AIMA serves as the voice of the industry throughout the world with regulators and other authorities, holding its international regulatory forum every other year. Specific output includes:

- Guide to MiFID
- Regulatory and tax "snapshots" of the industry in over 30 countries,
- Guidance on Capital Adequacy requirements
- Submissions to regulators and other authorities around the world on their hedge fund consultations, regulation and tax inplementations.

AIMA is committed to developing industry skills and education standards and is a proud co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

Enhancing understanding, sound practices and industry growth
www.aima.org

Appendix 2: AIMA Asset Pricing Committee

AIMA Asset Pricing Committee

Co-chair	Olwyn Alexander*	PricewaterhouseCoopers
Co-chair	Kieran Conroy*	Citco
Chief editor and author	David Woodhouse*	Fauchier Partners
Authors	David Aldrich	Bank of New York
	Evans Apeadu	Balysny Europe Asset Management (previously at RAB Capital Plc)
	Rebecca Berlow	Morgan Stanley
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	Olivier Champagne	Straper
	Guy Clayton	Morgan Stanley
	Hugh Crehan	KPMG
	Simon Firth	Kaye Scholer
	Tim Fletcher	Semper Macro
	Daniel Harris*	D Harris & Co
	Elsa Heitzig	JP Morgan Hedge Fund Services (previously at DPM Mellon)
	Joseph Henkel	SEI
	Andrew Johnston	Man Investments
	Mike Ketley	Caliburn Capital Partners
	Julian Korek	Kinetic Partners
	Gerald Lins	ING Alternative Asset Management
	John Maltby	DKR
	Barry Rome	Kinetic Partners
	Christopher Rose	Lombard Risk
	Karen Tyrrell	Bisys
Co-ordinator	Emma Mugridge	AIMA

* Contributors to AIMA's 2005 study on Asset Pricing and Fund Valuation in the Hedge Fund Industry

We are most grateful to those individuals who reviewed the Guide, including:
Alain Reinhold, ADI Alternative Investment
Jim McGovern and Rob Maxwell, Arrow Hedge Partners, Inc
Shinichiro Shiraki, Asuka Asset Management, Ltd
Justine Lee, Colonial First State Investment Managers (Aus) Ltd
Peter Douglas, GFIA Pte. Ltd
Jeff Landle, Hardt Group Advisors, Inc.
Kok-Ying Lee, LaCross Global Fund Services
Christian Thompson and Suzanne Pattison, Man Investments
Melissa Hill, Sabre Fund Management Ltd
The Guide was also reviewed by a further four fund of hedge funds managers, six hedge fund managers, two auditors and one pension fund. The Reviewers are based throughout Asia, Europe and the USA.

Appendix 3: Hedge Fund Stakeholders

Hedge Fund Stakeholders

Stakeholder	Definition	Typical involvement in valuation process
ADMINISTRATOR	An entity, usually independent of the Investment Manager, who provides a range of services to the Fund under the terms of an agreement with it (often in the form of a Service Level Agreement), including shareholder services, registrar and anti-money laundering services, reconciliation services and record-keeping functions. Some Administrators offer "integrated" solutions which allow Investment Managers to outsource some of their own back-office functions.	In the majority of cases, the Administrator acts as Valuation Service Provider as part of its services to the Fund. Note that if the Administrator is described as an "NAV Calculation Agent", it is not a Valuation Service Provider but merely carries out an arithmetical check on an NAV produced by another party (usually the Investment Manager). In such a situation, the Investment Manager would be responsible for the determination of the Fund's NAV with no meaningful input from the Administrator. The Administrator may also be described as providing an "NAV Lite" service. In these situations, the NAV of the Fund is essentially determined by another party (usually the Investment Manager) and the Administrator's role is to review the calculations for reasonableness. Again, the Administrator is not acting as a Valuation Service Provider according to AIMA's definition.
AUDITOR	The Auditor issues a written opinion upon the fair presentation of the Fund's annual financial statements, in accordance with the Fund's applicable accounting and auditing standards, on the basis of a year-end audit of the Fund's books and records.	The audit involves a review of the Fund's valuation policies and procedures at year-end, and, depending on the risk assessment by the Auditor of material misstatement, would normally include a level of substantive testing of position valuations. The audit opinion cannot be relied upon as a full verification of a Fund's formal NAV throughout the year, although in conducting its procedures the Auditor will review the valuation policies and procedures in place during the period under audit. The Auditor may provide other attestation services at the request of the Fund's Governing Body. However, independence must always be maintained by the Auditor in accordance with the applicable standards, which may vary by jurisdiction.

Hedge Fund Stakeholders

Stakeholder	Definition	Typical involvement in valuation process
CUSTODIAN	A bank, trust company or other financial institution that holds and protects a Fund's assets and provides other services, including collecting money from investors, distributing redemption proceeds, maintaining margin accounts, registering investments and exercising options. Usually a Fund's Prime Broker(s) will perform the role of Custodian.	While a Custodian has an important role to play in verifying the existence of investments, it is unusual for them to become involved in the formal NAV process. Custodian statements commonly report market values but often contain disclaimers as to the accuracy of the values or reliability for the purposes of Fund accounting.
FUND	The Fund is a collective investment scheme, typically established in the following ways: 1. In offshore jurisdictions such as the Cayman Islands, the Fund will usually be established as a Limited Liability Company. 2. Funds established under the laws of a US state such as Delaware usually take the form of a Limited Liability Partnership. 3. Some Funds in offshore jurisdictions are established as Unit Trusts, although this is a comparatively rare structure. The Fund has legal identity but in practice decisions on its behalf will be made by its Governing Body.	

Hedge Fund Stakeholders

Stakeholder	Definition	Typical involvement in valuation process
GOVERNING BODY	A Governing Body generally supervises and oversees the conduct of its Fund's affairs, even though it will delegate day-to-day functions to other parties such as the Investment Manager and Administrator. The composition of the Governing Body will depend upon the Fund's structure and jurisdiction: 1. A Fund established as a Company will have a Board of Directors as the Governing Body. The Board may include representatives of the Investment Manager, and directors selected by the Investment Manager, although there is an increasing trend for independent non-executive directors of stature to be appointed to hedge fund Boards. 2. A Fund established as a Partnership will usually have a General Partner as Governing Body. Typically the General Partner will be the Investment Manager. 3. A Fund established as a Trust will have a Trustee as the Governing Body. The Trustee is usually an independent licensed company.	The Governing Body will have overall responsibility for the valuation of the Fund. It will typically delegate day-to-day responsibility for the production of the NAV to a Valuation Service Provider. Note that, in Partnership structures, the General Partner (and therefore the Governing Body) may be the Investment Manager. In these circumstances a Valuation Committee is often established to oversee the valuation of the Fund.
INVESTMENT MANAGER	Often referred to as the Investment Advisor in the United States. The Investment Manager enters into an agreement with the Fund to make investment decisions on its behalf, usually on a discretionary basis, in return for a management fee (based on NAV) and a performance fee (a percentage of NAV appreciation over a given period). The performance fee is sometimes also referred to as an incentive fee.	1. In a minority of cases the Investment Manager will act as the Valuation Service Provider (sometimes referred to as "self-administration"). 2. For portfolios with a hard-to-value component, the Investment Manager is likely to have material input into the valuation process and may be the primary source for the valuation of certain positions.

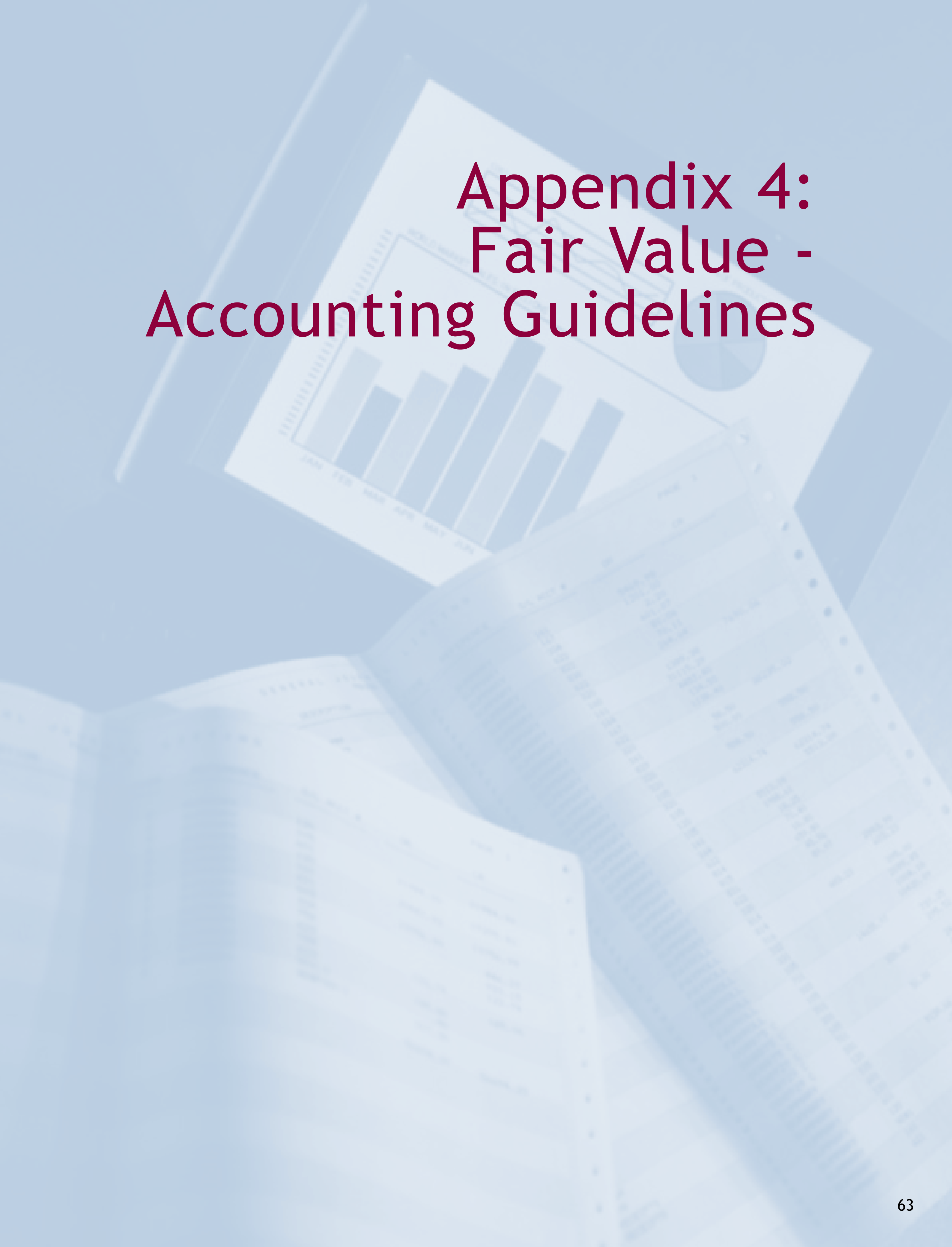
Hedge Fund Stakeholders

Stakeholder	Definition	Typical involvement in valuation process
INVESTOR	Investors in hedge funds can be categorised in many ways but the most clear distinction is between fund of hedge funds managers and direct investors: 1. Fund of hedge funds managers: These entities manage diversified portfolios of hedge funds (usually in the form of collective investment schemes), and provide their investors with services such as fund selection and risk management in return for a fee. 2. Direct investors: Hedge funds are aimed primarily at institutional and sophisticated investors. Direct investors include pension funds (public and private), endowments, foundations and family offices.	Investors, especially fund of hedge funds managers, may perform due diligence on the integrity of a Fund's valuation process, but they will not be involved directly in the formal NAV process.
PRIME BROKER	A large bank or securities firm that provides various back-office and financing services to hedge funds and other professional investors. Prime Brokers can provide a wide variety of services, including trade reconciliation (clearing and settlement), custody services, risk management, margin financing, securities lending for the purpose of carrying out short sales, recordkeeping and investor reporting. A prime brokerage relationship does not preclude hedge funds from carrying out trades with other brokers, or employing others as Prime Brokers.	Prime Brokers will typically provide Investment Managers with informal pricing for a Fund's portfolio. However, it is unusual for Prime Broker valuations to be relied upon in the formal NAV process. Some Prime Brokers have affiliates who act as Administrators and/or Valuation Service Providers.
REGISTRAR	The organisation that maintains a registry of the share owners and number of shares held for a hedge fund. Usually the Fund's Administrator also performs the role of Registrar.	

Hedge Fund Stakeholders

Stakeholder	Definition	Typical involvement in valuation process
REGULATOR	Independent organisation, usually governmental, that oversees financial markets, transactions and participants. Often seen as the protector of individual investors. Most, but not all, hedge fund Investment Managers are registered with their national Regulator.	Regulators may, in their supervisory role, inspect the valuation procedures and controls of those Investment Managers and Valuation Service Providers who are under their national jurisdiction.
VALUATION COMMITTEE	Some Governing Bodies delegate oversight of the valuation process to a Valuation Committee. This may be a sub-committee of the main Governing Body, or a separately constituted Committee.	Valuation Committees are a particularly useful intermediate oversight body when: 1. The Governing Body is the Investment Manager. 2. The NAV process is complex and requires monthly decision-making.
VALUATION SERVICE PROVIDER	Valuation Service Provider is the term used throughout this Document for the party who is primarily responsible for producing the NAV of the Fund in accordance with the Valuation Policy Document.	The Fund's Administrator often acts as Valuation Service Provider, although the role may be taken by another competent party. For some hedge funds, the Investment Manager acts as the Valuation Service Provider.

Appendix 4: Fair Value - Accounting Guidelines



Fair Value - Accounting Guidelines

What exactly is meant by "Fair Value"? The accounting standards and regulators provide the most commonly accepted definitions.

In Europe, the EU Directive on fair valuation adopts the definition put forth by International Financial Reporting Standards ("IFRS") which state that "Fair Value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction".

US Generally Accepted Accounting Principles ("US GAAP") define fair value in a similar manner as "the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale". The US Investment Company Act of 1940 states that "the value of securities for which market quotations are readily available is the market value, for all other investments the value is as determined in good faith by the board [of the Company]".

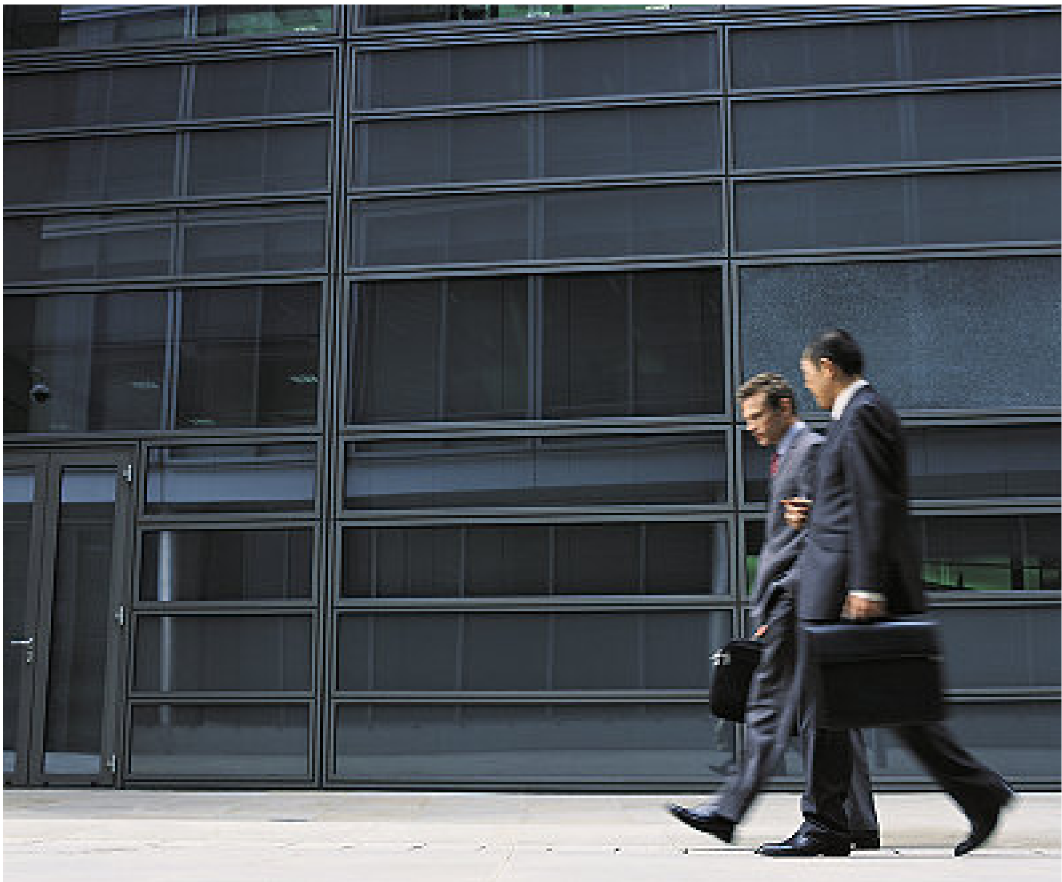
The Financial Accounting Standards Board ("FASB") in the US recently issued FAS 157 to examine fair value measurement, proposing a single definition of fair value under US GAAP and providing a framework for how to measure and determine fair value. The goal is to increase consistency and comparability in estimates of fair value, as well as enhancing transparency through enhanced disclosure. FASB proposes a revised definition of fair value as "...the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability". FAS 157 describes three different valuation techniques: the market approach, the income approach and the cost approach. The sufficiency and quality of data available to estimate fair value is examined in choosing the valuation technique, which must be consistently applied. FASB also divides the fair value hierarchy into three levels. The first level is directly observable market prices where there are quotations for identical assets or liabilities in active markets. Level three investments are valued using models with significant entity-derived inputs (e.g. inputs derived through extrapolation or interpolation but that are not corroborated by other market data). Level two then covers all other investments on the spectrum between these extremes. It is generally accepted that if an investment is freely traded in a deep, liquid market the best estimate of fair value is the current exchange-traded price. However, once the investment moves from this "ideal" valuation scenario a number of factors must be considered in determining valuation, which may include:

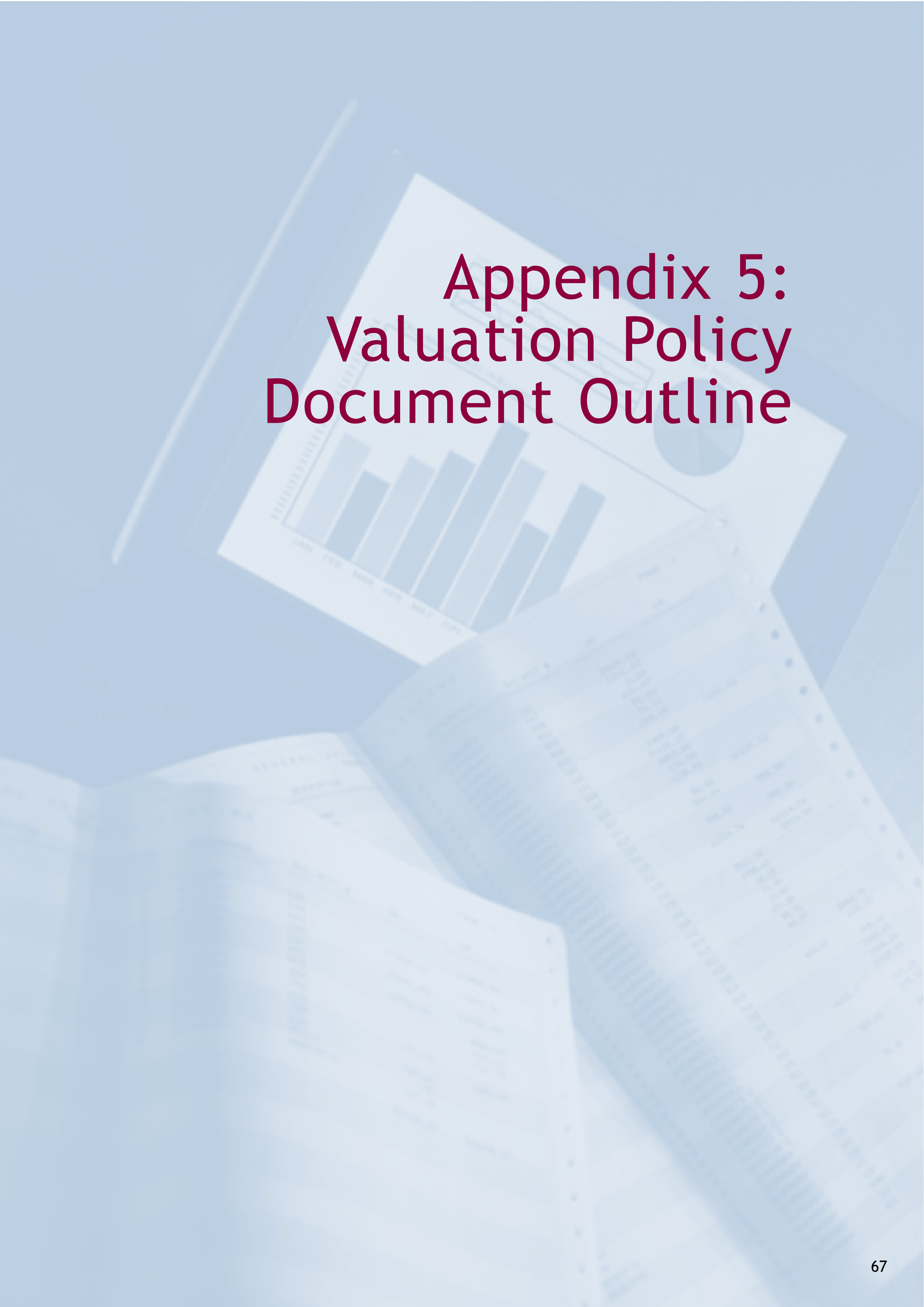
- Liquidity
- Accounting treatments
- Frequency of trading
- Currency fluctuations
- Economic/Industry Developments
- Value of similar financial instruments
- Changes in interest rates
- Reliability of models (if used)
- Reliability of input data to models (if used)
- Reliability of estimates
- Reasonableness of assumptions

Fair Value - Accounting Guidelines

In summary, there is broad consensus on the definition of fair value, but the determination of fair value can lead to divergence in approaches, estimates and assumptions which can cause a significant variation in the fair value estimate produced. As emphasised in the various sections of this Guide, it is therefore essential for a Fund to have a Valuation Policy Document. The stakeholders in the valuation process should ensure that the policies are consistently applied and reflect current sound practice in the industry.

Determining fair value where no exchange-traded price exists is more of an art than a science, as a number of assumptions and estimates must be made. As a final test in estimating the fair value of a non-exchange-traded position, it should be benchmarked to the definitions above: is the price what one would pay/receive for this investment in an arm's length transaction with knowledgeable market participants?





Appendix 5: Valuation Policy Document Outline

Valuation Policy Document Outline

This outline is for guidance only. The suggestions listed are not intended to be comprehensive; conversely, they will not all be appropriate in each individual case.

Valuation Policy Document of [NAME OF FUND]

This Document remains the sole property of [NAME OF FUND]. The Policy was prepared by the [INVESTMENT MANAGER] and [VALUATION SERVICE PROVIDER] of [NAME OF FUND]. The Policy was approved by the [GOVERNING BODY] on ___________.

Objective

For example:

The Fund's valuation policies and procedures are designed to ensure that all instruments are valued in accordance with the Fund's Offering Document. The value of those instruments will form an integral part of the Net Asset Value calculation on which investors subscribe and redeem on each and every dealing day. The aim of the policies and procedures is fairness to all investors in the Fund.

Responsibilities

This section would define the various stakeholders involved and outline their responsibilities:

- Governing Body
- Valuation Committee (if applicable)
- Investment Manager
- Valuation Service Provider
- Other (e.g. Auditor, independent accountant, pricing specialist)

If an affiliate or division of the Investment Manager is the Valuation Service Provider, the document may be expected to provide information on the personnel/departments assigned responsibility.

Oversight

This section would set down guidelines for the body responsible for oversight of valuation:

- Identity (i.e. Governing Body or Valuation Committee)
- Quorum
- Normal frequency of meetings
- Reports to be presented (e.g. exception reports from Valuation Service Provider)
- Outline of approval process for new models/sources
- Frequency of review of the Valuation Policy Document

If the Governing Body delegates its oversight function to a Valuation Committee, it may set out in this section matters that remain reserved for its approval.
This Outline covers Escalation under a separate heading but that subject may also be dealt with here.

Valuation Policy Document Outline

Valuation Sources

This section might list a price source matrix, perhaps configured as follows:

Type of Asset	Primary Source	Secondary Source	Accounting Policy	Cut-off time	Tolerable Variance

For certain instruments, there may be a hierarchy of more than two sources.
The Accounting Policy column would typically state which part of any price spread should be used (e.g. bid, ask or mid).
The Document may indicate which party would usually be responsible for accessing each price source.
Notes may be provided if the accounting policy is complicated or if access to a source requires a procedure with several steps.

For more complex instruments, the section may provide guidance such as:

- Method of deriving an average price from broker quotes
- Data to be input to pricing models (including details of sources, steps in the input process and the party responsible for input)
- Approved pricing specialists (to be consulted if the usual sources are unavailable)
- Level of documentation required for private positions

Control Procedures

The size of this section may depend on the complexity of instruments traded, but it could include:

- Procedures for back-testing
- Definition of stale prices and procedures for isolating them
- Monitoring of trading volume for less liquid instruments

Escalation

This section would outline as clearly as possible the Fund's escalation procedure if the Investment Manager or other party requests a deviation from the Fund's usual policies:

- Definition of an Investment Manager override
- Definition of materiality
- Governing Body (or Valuation Committee) quorum
- Acceptable format and deadline for representations
- Timescale for decision
- Guidance on possible adjudication/arbitration by pricing specialists
- Protocol for minute-taking

The escalation procedures may be used as the basis for a procedure to approve side pockets, should the Fund have side pocket provisions.

Valuation Policy Document Outline

Other

The Document may also address subjects outside the scope of this Guide, such as:

- Policies on income recognition, expense accruals and performance fee calculation
- Agreed timetables for delivery of NAV reporting

Appendices

Possible appendices may include:

- Excerpts from the Offering Document relating to valuation policies
- Latest accounting policies note from the audited financial statements
- Contact details for all relevant parties

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