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Plenary 3

Hedge Funds – New Regulatory Challenges

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What driver for fair value as a regulatory principle: legality or legitimacy?

Fair value… "Fair" I must confess I rushed to the dictionary. I first found "pleasing to the eye", like a fair lady, or fine and dry, with "fair weather"…Nothing about "fair play", but many synonyms which are better drivers for our subject: just, equitable, impartial, unbiased, dispassionate, objective.

The following quote from an auditor probably sums it up:

"Fair value is a wonderfully powerful expression in the English language… It conveys the very essence of truth and fairness…What possible objections could there be to financial statements that report assets and liabilities at their fair value?"

Nonetheless, in 2005, several hedge fund professional associations deemed it necessary to go beyond the concept and made an inventory of current practices, which led to a set of recommendations.

In 2006, the European Commission called upon a group of the industry's practitioners to identify what they considered to be the principal recommendations to enhance the European framework for alternative investment. I participated in this group and we prepared a report where the final recommendation addresses hedge fund asset valuation. Initially, the group noted very clearly that:

"…the issues of valuation …. are of relevance to the global hedge fund industry and not simply the industry in Europe"

and then the group recommended:

“Nevertheless the group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry-led codes of conduct.”

We acknowledge the consultation report released by IOSCO in March 2007, as the regulator can stand back from precise and compulsory rules and instead propose principles, the implementation of which can be easily guided and adapted by the professional bodies.

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This aside, and now with the practitioner’s hat on, I would like to develop what we called in the above-mentioned report, the “challenge of valuation”. I have identified three main challenges:

- Number one: to be sure to have identified all of the positions in the entire portfolio;
- Number two: ensure that each position is valued in a fair and proper manner:
- Number three: apprehend and monitor the various conflicts of interest that may go with the valuation process,

and beyond these three challenges I would also like to mention the impact of liquidity or illiquidity on the valuation of the funds.

<u>1st challenge</u>

The valuation of the fund begins with the determination of the fair market value of all the positions that make up a fund’s portfolio. The key word here is **ALL** the positions. With many products and especially OTCs, with many counterparties, with several accounts with sometimes multiple prime brokers and, often, hundreds of trades a day, dividends and coupons, fees and funding costs, ALL is a true challenge. Due diligence are always interested in the organisation of operations and the consistency of the information flow between the manager, counterparties, prime brokers and the administrator. Due diligence also like to know who executes asset verifications and when? How non-confirmed operations are dealt with, and, as this can be a real valuation risk, how are the discrepancies addressed and resolved?

So, the first challenge of valuation is an operational challenge.

2nd challenge

It is easy to price liquid and frequently-traded instruments but this is not the case for illiquid or complex instruments, and it is worth noting that the wording changes. We no longer talk about price but value. Price is a non-arguable figure: the price derives from a transaction. Value, inversely, is generally not supported by a transaction. A value is a convergence of opinions between the market participants at a given instant.
The big difficulty appears when we have to value really illiquid assets such as very exotic OTC products or non-quoted equities as there may be different opinions from different sources. Most principals will recommend an independent valuation of the assets. By experience this is necessary but never sufficient and, in my view, a valuation is not secured as long as figures provided by the administrator and the manager differ. There should at least be a convergence of opinion between these two specialists.

So, the second challenge is to obtain valuations that would match the prices that could be observed in real transactions.

3rd challenge

Why is it that the only conflict of interest that is generally identified is the one between the hedge fund manager and the investors? Obviously such conflict of interest may exist but when a manager is regulated, I believe that the potential consequences of any such misconduct should be a sufficiently strong deterrent.

There are also other conflicts of interest to address, and they are between the investors themselves. They derive from valuation errors or approximations. In theory, the valuation of a fund is equal to the sum of the proceeds that would be obtained if all the positions were liquidated and also, symmetrically, it is the amount of money that would be necessary to replicate all the fund's positions. This is theoretical. And it hardly reflects the reality which is that valuation is the price at which investors subscribe or redeem: practically if the fund is overvalued, the investor who redeems is favoured at the expense of the existing investors as it will be necessary to oversell assets to honour the redemption payment. Symmetrically, if the fund is undervalued, a subscriber will be favoured as his investment will not be sufficient to replicate the pro rata of the existing positions.

So, the third challenge of valuation is all about ethics.

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Now a word about liquidity and valuation. Whatever efforts and methods are employed, even a perfect valuation can only be true for an instant. But for each investment or redemption, it will take time to invest or organise such liquidities. As a matter of fact, funds, and especially hedge funds, are genuine liquidity transformers. When it would be necessary to spend days or weeks to unwind or to replicate a portfolio, the fund immediately provides such positions at a fixed price. This "service" has a cost which is not very visible because it is finally borne between the investors themselves. It is the "liquidity cost", which, in normal market conditions, is about half of the bid and ask spread. However, if for any reason liquidity on the markets came to dry up, then we would face an "illiquidity cost", which derives from the impact on the market of the unwinding of a big position and such illiquidity cost is very difficult to predict.

Serious managers are careful to organise the fund's liquidity according to the liquidity of the underlying assets. And there are several tools to achieve this, such as notice periods, redemption fees, lock-up, gates etc. The main objective of liquidity restrictions on the shares of the funds is not to please the manager, but rather to protect the fund's existing investors. Any professional investor will appreciate this.

The attention of the regulators should also be attracted to the problem of asymmetry between the liquidity of the underlying assets and the shares of the hedge fund. If market conditions deteriorate, then depreciations could quickly become contagious and could turn into a more or less catastrophic scenario which has been called "the great unwind", and could manifest itself in both triggering a bursting of a bubble, and then on through the aftermath.

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Conclusion

The principles for the valuation of hedge fund portfolios proposed by IOSCO in their consultation report show that regulators have clearly taken into account that it is difficult to accompany the evolution that we are experiencing via a fixed regulatory framework. They made the choice to set principles that the industry will examine in order to propose the implementation methods and resources and also that the investors are encouraged to check and to control through adapted due diligence.

Such is the way our profession is evolving. We do not have to apply strictly precise rules but rather we have to make our choices, take our responsibilities and maintain the capacity to demonstrate that all our actions are legitimate according to the decreed principles as, at the end of the day, one could say that fairness in valuation has been achieved, when accountability for the decision process is transparent to all.

I hope and believe that this will lead to even more self-imposed rigour and discipline in the hedge fund industry, for the benefit of more investors.

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