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Fund Valuation Under AIFMD

A SPECIALIST WORKSHOP FOR AIFM DIRECTORS, OFFICERS, ADMINISTRATORS, ACCOUNTANTS AND LEGAL/COMPLIANCE PROFESSIONALS

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Introduction

IAN BLANCE

MANAGING DIRECTOR

VOLTAIRE ADVISORS LLP

Morning Agenda

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- 0900 **Introduction** – Ian Blance, Voltaire Advisors
- 0915 **Growing Up: A New Environment for Hedge Funds** – Niamh Mulholland, KPMG
- 0945 **AIFMD & Valuation** – Ken Owens, PwC
- 1015 **Coffee**
- 1045 **AIFMD & the External Valuer** – Ryan McNelley, Duff & Phelps
- 1115 **Evaluated Pricing & Fund Valuation Requirements To Mitigate Risk and Regulatory Exposure** – Ozan Tuzunalper, Thomson Reuters
- 1145 **AIFMD, Pricing Vendors & Models** - Ian Blance, Voltaire Advisors
- 1200 **Lunch**

Opening Remarks

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Regulator focus on Buy-Side (SIFI debate)

Policy makers assessments of the recent financial crisis

Significant on-going attention to fund policies & procedures

FATCA

US Foreign Account Tax Compliance Act

Timeline

- **Signed into law** in March 2010; from **Aug 2013** IRS online registration available
- **From July 2014** withholding and FATCA compliant procedures must be in place

Key Themes

- **Rationale:** prevent tax evasion by US investors through non-US accounts; **FDIP income** is fixed, determinable, annual or periodical income sourced in US
- **Foreign Financial Institutions FFI** defined as holding financial assets for the accounts of others; can enter into an agreement with US authority IRS to be identified as participating **PFFI**; entails duty to report to US authorities any accounts held by US investors; local reporting possible where countries have signed Intergovernmental Agreement (IGA) with the US IRS
- Non-participating **N-PFFIs** will be subject to **30 % tax withholding** of all US-sourced payments such as dividends/interests paid by US corporates
- **Operational challenges:** to identify end-investor, to verify as US citizen through chain of intermediaries; new documentation and investor disclosure requirement towards US authorities; change of IT systems
- Applies also to **"pass-through payments"** including those "attributable to" withholdable payments/US sourced income resulting in a wide scope

DODD-FRANK-ACT / VOLCKER / CFTC

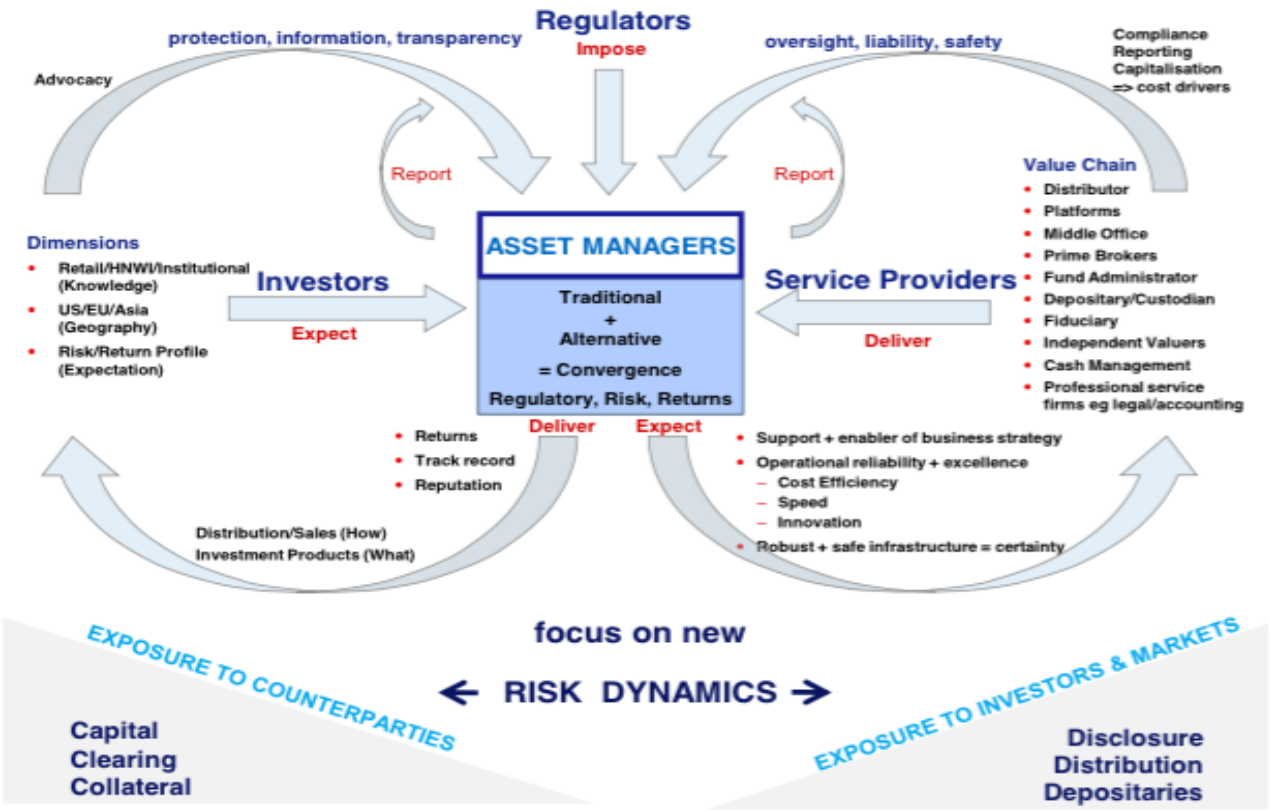
US comprehensive rules reforming financial services

Timeline

- **Signed into law** in July 2010; phased implementation
- **Dodd-Frank effective from July 2011; Volcker Rule phased from July 2012**

Key Themes

- **US/non-US investment advisors** need to register with the US SEC if AUM greater than USD $100/25 million respectively attributable to US investors
- **Consequence are stricter record keeping, reporting requirements, oversight and inspection** on eg AUM, capital leverage ratios, counter-party credit risk exposure, trading and investment positions, valuation policies, liquidity and short selling provisions, books and records retention: **Form PF for HFs**
- **US CFTC** regulates swaps; has identified 38 areas divided into 8 sections: swap dealers, clearing, trading, data, products, enforcement, position limits, other
- **Volcker Rule** mandates the segregation of banking and proprietary trading and from sponsoring or investing in AI management functions; leading to spin-offs of proprietary trading desks, HF/PE arms by banks (UK equivalent "Vickers report")
- **Central clearing of OTC derivatives** same concept as European EMIR rules agreed by the G20 in 2009



AIFMD

EU Alternative Investment Fund Managers Directive

Timeline

- **Level 1** Directive in force since July 2011; effective for industry from July 2013
- **Level 2** final delegated regulation adopted in Dec 2012, in force from July 2013

Key Themes

- **Applicable:** to **non-UCITS funds**, including hedge funds, private equity
- **EU domicile:** applicable if the alternative fund (AIF) or manager (AIFM) or investor is domiciled in one of the EU 28 member states or 3 EEA countries
- **Passport:** EU managers can apply for a passport from July 2013 (equivalent concept to UCITS); for non-EU managers from 2015, until then private placement
- **Third-country / marketing rules:** non-EU funds eg domiciled in Cayman, Guernsey, Jersey, Switzerland etc will require prior authorisation in EU
- **Reporting obligation:** regarding investment strategies, risk management, governance, remuneration: disclosure required to both, regulators and investors
- **Delegation:** similar to UCITS/MiFID, but aims to prevent any potential approach by service providers of "outsourcing risk or liabilities"
- **Depositary liability rules outlined below:** a single depositary for each AIF needs to be appointed for all non-UCITS funds; impact on fund economics

UCITS IV / V

EU Mutual Funds

Timeline

- **UCITS IV** in force and mostly implemented by EU 28 member states
- **UCITS V** proposal published in July 2012; target industry effective date end 2014

Key Themes

- **Passport:** in force for management companies
- **Marketing rules / KIID:** Key Investor Information Document will be further standardised + have more information on risk, calculation methodology, charges
- **Master-feeder structures:** a more harmonised approach across Europe may stimulate growth in cross-border pooling and mergers, but tax issues remain
- **"NEWCITS":** HF managers offering more UCITS products since the possible inclusion of **derivatives** tapping into new investor segments + target markets
- **Depositary: new liability rules as in AIFMD** expected spill over into UCITS V whereby depositaries are
  - liable for the loss of financial instruments held in custody
  - have the obligation to return corresponding amount without undue delay
  - only following the return may prove – cumulatively – that the loss is a result of 1) an external event, 2) beyond its reasonable control, 3) the consequence was unavoidable, 4) despite efforts to the contrary

BASEL III

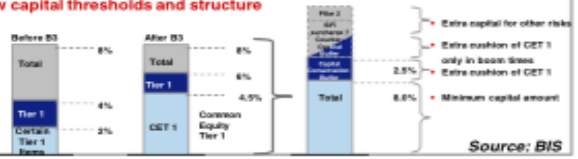
Global Capital Rules for Banks & Insurance

Timeline

- **Banking: G20 -> by end 2012; EU CRD IV**; US Dodd Frank Act provisions
- **Insurance: EU Solvency II by 2015** – similar aim as B3 for insurance sector

Key Themes

- **De-risking/-leveraging:** new global standards designed to strengthen capital and liquidity; stress testing; creating a more robust and resilient banking sector
- **Systemically important financial institutions (SIFIs)** to have loss absorbing capacity beyond existing standards; "living-wills" recovery & resolution plan **RRP**
- Higher risk weightings on **derivatives**: 2% against initial margin posted to the **CCP**; clearing members to hold capital against exposure to clients
- **New capital thresholds and structure**



Source: BIS

EMIR

European Market Infrastructure Regulation

Timeline

- **EMIR** entered into force Aug 2012; technical standards in force from March 2013
- **Industry implementation phased from Jan 2013 onwards** (G20 commitment)

Key Themes

- **Central clearing of OTC/ETD derivatives through a CCP** similar to US Dodd-Frank; otherwise capital charges apply; need to **review risk management**
- **Common governance standards for CCPs** and pan-EU requirements for CCP interoperability regarding equities; third country CCPs need to meet new EU standards if used by EU counterparties
- **Increased margin and collateral requirements:** portability and eligibility of collateral not yet finalised, eg required is "highly liquid collateral"
- **Operationally** need to review number and type of collateral relationships with clearing brokers factoring in all risk management aspects & optimization
- **Mandatory daily independent valuation and collateralisation** of those trades that are not cleared through a CCP centrally
- **Trade repositories:** mandatory reporting of all derivative contracts

MiFID/R II

EU Markets in Financial Instruments Directive

Timeline

- **MiFID II** Regulation & Directive proposal published in Oct 2011
- **Industry implementation targeted from 2015 or after**

Key Themes

- **Wider scope in 3 aspects: 1)** new instruments, **2)** venues, **3)** activities; captured will be eg: almost any type of derivatives; organised trading facilities (OTFs), "dark pools"; high frequency / algo / auto trading activities
- **Derivatives on-exchange trading (ETD):** if sufficiently liquid (standardized) derivatives shall be traded on-exchange; then cleared centrally (EMIR)
- **Commodity derivatives** under review re efficient functioning of its hedging and price discovery purpose; potential position limits designed to support liquidity, greater investor transparency through aggregated weekly market breakdown
- **Structured UCITS classified as complex products – marketing impact:** MiFID sales and transparency rules will apply; increased operational complexity
- **Depositary:** now classified as "investment advice" instead of just "ancillary service" under the EU Securities Law Legislation and consequently under MiFID increasing compliance requirements and costs

SHORT SELLING (SSR)

Short Selling Regulation and Credit Default Swaps

Timeline

- Adopted in Sep 2011; effective for industry from **Nov 2012**

Key Themes

- EU regs **ban uncovered sovereign CDS** but member states can suspend rules
- **Covered** short sales require share to be "located" & settlement can be effected
- Ongoing duty to **report net short positions** to regulators (>0.2%) and publicly to market (>0.5%) on named basis plus for each 0.1% increase above the threshold

MAD/R II

EU Market Abuse Directive / Regulation

Timeline

- Proposal published in Oct 2011; possibly effective for industry from **Jan 2015**

Key Themes

- Wider scope: **1)** new instruments, eg OTC & commodity derivatives; **2)** markets, eg MTFs & other venues; **3)** behaviours, eg **attempts** to manipulate the market including manipulation of any benchmark or index eg LIBOR rate-fixing

FTT

Financial Transaction Tax

Timeline

- **France:** effective for industry from **Aug 2012**; other EU countries may follow
- **EU:** issued proposal in Sep 2011 for **Dec 2014**, pan-EU enhanced cooperation

Key Themes

- **0.1%** for transactions in equities (& bonds; **0.01%** of notional derivatives value)
- EU: potential very wide scope: all markets, all instruments, all actors in 'FTT land'

Source: Citi Global Regulatory Affairs Regulatory Ecosystem

“

Confusion now hath made his masterpiece

”

WILLIAM SHAKESPEARE, *MACBETH*

Valuation as an Existential Issue

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- Yes, need to **Comply** with regulation …

… but sound valuation also needed to:

- **Survive**, and;
- **Thrive**

Sound valuation is an **existential issue** for hedge funds

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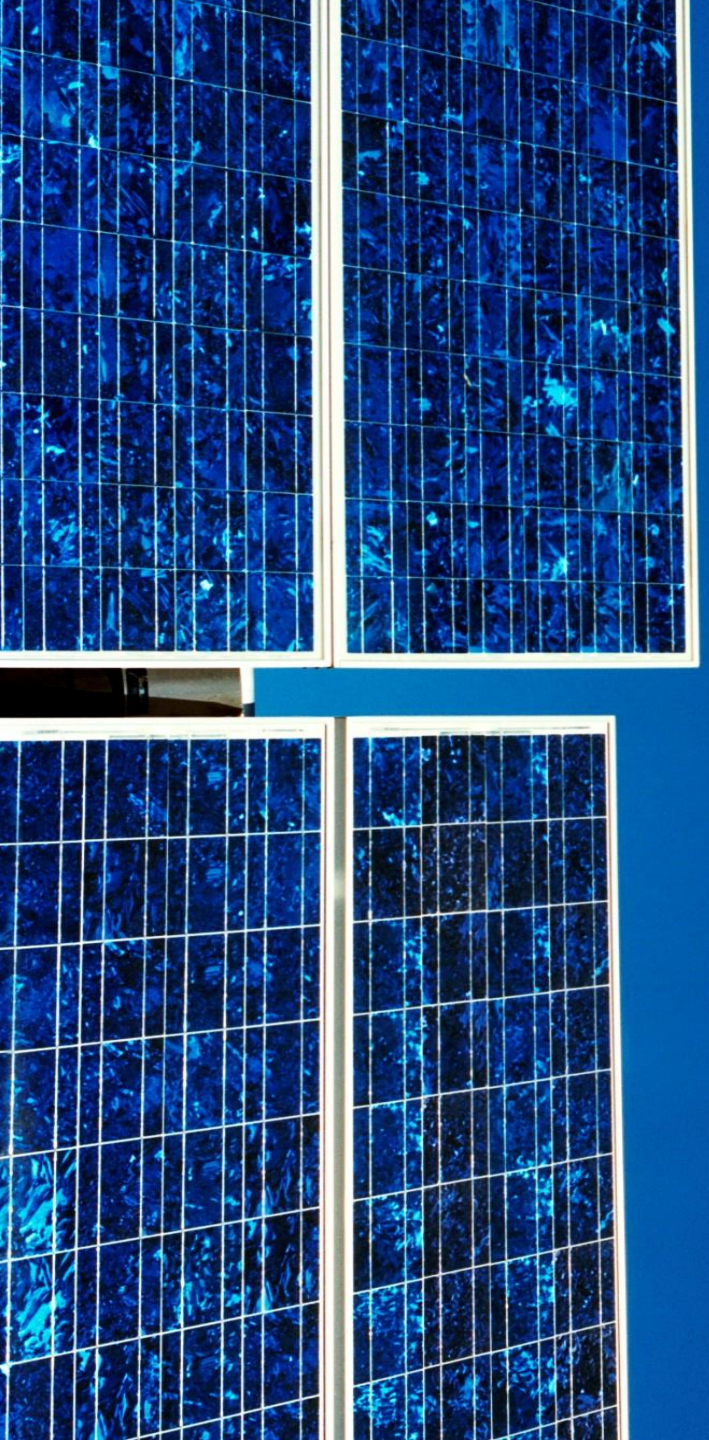
Growing Up: A New Environment for Hedge Funds

NIAMH MULHOLLAND

DIRECTOR

KPMG



Growing Up: A New Environment for Hedge Funds

Fund Valuation under AIFMD – Voltaire Advisors
5 May 2016

Overview

- **Overview of the Objectives of AIFMD**
- **Impact of AIFMD – Key Points from the 2015 Global Hedge Fund Survey**
- **On-going Discussions**
- **What's Next?**

Background to AIFMD

Reasons for AIFMD

Response to the last financial crisis, there was a global regulatory drive for greater financial transparency and investor protection.

Although AIFs were not central to the financial and economic crisis, policymakers considered that they, like all other financial sectors, deserved some attention.

- **AIFMD was proposed by the European Commission in 2009.**
- **Entered into force in 2011**
- **Entered into application in 2013**
- **Will be reviewed by the European Commission in 2017**

One purpose of AIFMD was to enable AIFs and AIFMs to register in just one EU Member State and thereafter be free to market in all EU Member States – thus enhancing the single market

AIFMD was quickly joined by other key post-crisis architectural pieces of legislation such as EMIR, MiFID II

Post Crisis Regulation of Hedge Funds

European Supervision

- Better regulation of the activities of AIFMs at EU level, through improved transparency and supervision.
- Some risks associated with AIFMs had been underestimated due, in part to the national perspective of existing rules.

Transparency

- AIFMD Reporting: Article 3 (Exemptions) and Article 24 (Transparency Requirements) establish a number of requirements under which information has to be reported to competent authorities about AIFMs and the AIFs they are managing and, where relevant, marketing.

AIFMD

Investor Protection

- Enhancing protection for investors, by curtailing some of the riskier behaviour of AIFMs.
- Imposition of new depository standards.
- New Investor disclosure rules.

Enhancing the Single Market

- Developing a single EU market for Alternative Investment Funds, similar to that which exists for UCITS funds.
- Transition from the marketing of AIFs EU-wide by complying with the differing national rules of each EU Member State.

Key Items to be regulated under AIFMD (1)

- **Registration and authorisation of AIFMs**

AIFMs must apply for authorisation to the regulator of their home member state, or in the case of non-EU AIFM, the member state of reference. For authorisation to be granted, the Regulator must be satisfied that the AIFM is capable of complying with the directive, has sufficient capital and assets and is run by individuals who have sufficient experience and who are of good repute.

- **Initial capital required to set up a business**

Internally managed or self-managed funds are required to have €300,000 in initial capital and external managers of one or more funds must have at least €125,000, increasing on a sliding scale to a maximum of €10 million according to the total value of assets under management. AIFMs must also have additional own funds which are appropriate to cover potential liability risks arising from professional negligence or hold professional indemnity insurance against liability arising from professional negligence.

- **Remuneration of managers and staff running the funds**

The AIFMD introduces requirements for the AIFM to have remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage excessive risk taking. Annex II of the AIFMD establishes a set of rules (largely based on those contained in amendments to the Capital Requirements Directive) with which AIFMs have to comply when applying the remuneration policies for certain categories of staff. ESMA's "Guidelines on Sound Remuneration Polices under the AIFMD" set out guidance explaining how firms may comply with the Annex II principles.

- **Designation, functions and liability of the depositary**

An AIFM must appoint a single depositary in respect of each AIF it manages. The depositary can either be an EU credit institution, an EU investment company or a UCITS depositary. In general, the depositary remains liable for the failures of its delegates. The AIFMD differentiates between the depositary's custody duties and safekeeping duties. The AIFMD provides that a depositary can avoid liability for loss of financial instruments, which are subject to the custody obligation, where the loss of the financial instrument is due to an external event beyond the reasonable control of the depositary, the consequence of which would have been unavoidable despite reasonable efforts.

Key Items to be regulated under AIFMD (2)

- **Functions of the valuator**

The valuation function may be carried out by the AIFM itself, or it may appoint an external valuation agent. Where the AIFM decides to carry out the valuation function itself, it must ensure that the process is functionally independent from the portfolio management and remuneration functions of the AIF and that measures are put in place to mitigate conflicts of interest. Where an external valuer is appointed, the AIFM must be able to demonstrate that the delegation is to an external valuer that is professionally recognised, can furnish professional guarantees and has been appointed pursuant to the AIFMD delegation provisions.

- **Liquidity standards and use of leverage**

The AIFM must set a maximum level of leverage for each AIF it manages. The AIFM must comply with this maximum at all times and must be able to demonstrate to its Regulator that the levels set are reasonable. The Regulator will assess the risks which the use of leverage employed by the AIFM could entail and may impose limits on the level of leverage that an AIFM may employ, or other restrictions on the management of the AIF.

- **Regular reporting to national supervisors to increase transparency**

The AIFMD requires detailed reporting to the competent authorities, including information in relation to principal markets on which an AIFM trades, instruments traded, principal exposures, important concentrations, illiquid assets, special arrangements, risk profiles, risk management systems, stress testing results, a list of all AIFs managed, leverage in the AIFs and sources of leverage. The AIFM will also have to respond to any additional regulatory requests issued from time to time.

- **Delegation of AIFM activities**

An AIFM must notify its Regulator if it chooses to delegate any of its functions. The AIFM must be able to objectively justify the entire delegation structure and will have to review the services provided by each delegate on an ongoing basis. It may only delegate its portfolio and / or risk management functions to regulated entities; where this condition cannot be satisfied, delegation is subject to the prior authorisation of the Regulator. The AIFMD provides that an AIFM may not delegate to the extent that it is no longer regarded as the manager of the AIF and is merely a “letter box entity”.

Where the delegate is in a non-EU country, cooperation arrangements between the Regulator and that of the non-EU country must be in place, the third country entity must be authorised or registered for the purpose of asset management and it must be effectively supervised by an independent competent authority.

2015 Global Hedge Fund Survey

Background to Research

- *The 2015 Global Hedge Fund Survey* looks at the impact that recent change is having on virtually every aspect of hedge fund management, from product mixes and fee structures through to markets and investor types.
- The Survey provides keen insights gathered from one-on-one interviews with some of the industry's largest and most successful fund managers.
- The report incorporates the views of more than 100 hedge fund managers representing approximately USD440 billion of assets under management (AUM).
- **Breakdown of respondents by AUM size**

< USD 500 Million AuM	USD 500 Million - USD 999 Million AuM	> 1 Billion AuM
43%	16%	41%

- **Geographical Breakdown of respondents**

North America	UK	Europe	Asia Pacific	Other
37%	28 %	16%	15%	4%

Overview

- *Growth:* The Industry has seen AUM grow by approximately 10 percent a year since the financial crisis, is positioned to continue along this growth path over the next 5 years.

- *Primary Source of Investment:* Institutional investors, who already account for roughly two thirds of the total hedge fund capital, will continue to eclipse high net worth individuals as the industry's primary sources of investment. This will catalyse significant changes in the way that managers structure, manage and market their products.

- *Fee Arrangements:* traditional fee arrangements will erode in the face of more customized models. The customization of fees and products, is just one strategy that managers are taking to attract institutional investors.

- *Impact of New Regulation:* Managers suggest that the growing regulatory burden is creating significant barriers to growth in most markets. Three-quarters of respondents said that they expect the number of hedge fund managers to either decrease or stay the same over the next five years.

Key Findings

- *Primary Source of Capital:* The majority of managers believe that pension funds will be their primary source of capital by 2020; public pension funds and sovereign wealth funds together will account for at least a quarter of capital inflows by then.

- *Institutional Investors:* **46%** of respondents expect to either alter their fund strategy or launch new products to attract institutional investors in the next 5 years, while more than two-thirds say they expect to offer specialized fee structures.

- *Customized Product Offerings:* Managers are moving towards customized product offerings with almost half **(47 %)** of all fund managers reporting that they already offer a fund of one or managed account solution and **21%** saying they plan to offer these solutions within the next 5 years.

- *Biggest Threat to the Industry - Regulation:* More than three-quarters **(77%)** cited increased regulation as the biggest threat to the industry overall; **84%** said that their operating costs had increased as a result of compliance obligations.

Key Topics (1)

- **GLOBAL ECONOMIC OUTLOOK**

Two major factors seem set to influence the alternatives funds industry over the coming years: (1) the state of the US economy and (2) the impact of an aging world population.

It is highly likely that hedge funds will play an increasingly important role in providing better diversification with greater liquidity when compared against other alternative investments such as private equity, infrastructure or real estate.

- **NEW INVESTORS**

Today, the vast majority (80 %) of managers say that their funds include some capital from high net worth investors. Barely half (54 %) say they already manage capital for corporate pension funds. While 42 % boast investment from public pension funds. *However, our survey demonstrates that a shift towards a larger focus on institutional investors is now underway. Indeed, most managers responding to our survey told us that – by 2020 – pension funds (both corporate and public) would be their primary sources of capital. Transparency more important to institutional investors than regulators?*

- **FUND STRATEGIES**

46% of respondents said that – over the next 5 years – they would either alter their fund strategy or launch new products into the market to attract investment capital from pension funds and the aging demographic. For closed funds, the focus has shifted onto performance rather than increased assets.

When asked what growth strategies they expected to use in order to attract increased investment, more than two-thirds pointed to some sort of specialized fee structures with respect to either incentive fees or management fees. Only around a third of respondents said they would use seed deals or increased liquidity options in order to drive growth.

Key Topics (2)

- **NEW MARKETS**

North America accounts for around 43 % of investors, followed by Europe (excluding the UK and Switzerland) who make up 17 % of investor capital, the UK (13%) Asia-Pacific (also 13 %) and Switzerland (9 %). Brazil, Russia, India and China (BRIC), emerging and frontier markets account for just 5 % of investors.

However, the data suggests that some of the greatest inflow increases in purely percentage terms over the past two years have come from developing and emerging markets. Likely, as a result of the shift in investor demographics and markets, the majority of managers say that — if they were to set up a new fund in the next 5 years they would most likely domicile their master fund offshore.

- **PRODUCT MIX**

The trend towards customized product offerings is clear. Almost half (47%) of all fund managers report that they already offer a fund of one or managed account solution. 21 % say they plan to offer these solutions within the next 5 years.

38 % of respondents said that they either had, or were developing, a UCITS fund (making it the second most popular product offering according to our survey). More than a quarter (27 %) said the same about 40-Act funds (the fourth ranked product).

- **BARRIERS TO GROWTH**

The fact that running a hedge fund management firm is becoming more complex and challenging – particularly for new entrants – is clear. Managers expect competition to decrease somewhat as a result of higher barriers to entry.

When asked what factors they believed to pose the largest threat to the growth of the industry over the next 5 years, more than three-quarters (77 %) cited increased regulation, 84% of respondents said that their operating costs had increased as a result of compliance obligations. The remainder said that costs had stayed the same (nobody suggested that their costs had decreased).

Matters Outstanding?

On-going discussions

Passport Extension	AIFMD introduced an EU marketing passport for EU domiciled AIFMs managing and marketing EU domiciled AIFs, whereas non-EU domiciled AIFMs remained subject to the national placement regimes (NPPRs) of each Member State where the AIF is marketed. European Securities and Markets Authority (ESMA) published two documents on 30 July 2015: ➢ its Opinion on the functioning of the EU passport for EU domiciled AIFMs and of the NPPRs; and ➢ its Advice on the application of the AIFMD passport to non-EU domiciled AIFMs and AIFs. ESMA's Opinion on the functioning of the EU passport and the NPPRs concludes that enough time has elapsed for them to be able conduct a definitive assessment and have recommended preparing a further opinion, which the European Commission have agreed to. ESMA considered the viability of extending the passport to six non-EU jurisdictions only: USA, Guernsey, Jersey, Singapore, Hong Kong and Switzerland. ESMA's Advice concluded that no obstacles existed to the extension of the passport to Guernsey and Jersey, while Switzerland was enacting legislation to remove any remaining obstacles. *The European Commission have invited ESMA to complete the assessment of the following countries by 30.06.2016:* USA, Hong Kong, Singapore, Japan, Canada, Isle of Man, Cayman Islands, Bermuda and Australia. If ESMA advises that the passport should be extended to specific countries, the Commission is required under AIFMD to adopt a legislative proposal to implement this within 3 months of receipt of the advice. The European Parliament and Council would then have 3 months (which may be extended to 6 months) to either approve or reject the Commission's legislative proposal.
Remuneration ***The date of application of the guidelines to UCITS managers and of the amendments for AIF managers is 1 January 2017, although the UCITS V provisions were applicable from 18 March 2016.***	ESMA's final guidelines on remuneration were published on 31 March and cover both the new UCITS V requirements and the existing AIFMD requirements and in so doing bring them into close alignment. This has been broadly welcomed by the industry. Senior management and portfolio managers might be subject to not only the UCITS V and AIFMD requirements but also those under CRD IV and MiFID II, all four being slightly different. This makes it difficult for firms to craft sound remuneration policies for affected staff. Reducing the number of differences is therefore sensible. *Proportionality:* However, unlike the draft UCITS V guidelines, the final ones are silent on whether the application of the principle of proportionality can result, or not, in the dis-application of certain of the remuneration principles. It therefore neither allows nor prohibits this. Instead, ESMA has written to the Commission seeking legal clarification (if necessary by legislative amendment), citing the very different nature of fund management to banking business.
Annex IV	While the first deadline passed almost 18 months ago (31 January 2015) Annex IV reporting arguably remains a challenge, in terms of meeting the reporting requirements. The sheer volume and detail of data required, its multiplicity of sources for each individual AIFM and AIF, is still a challenge for managers and national regulators.

What’s Next?

Post Crisis Legislation – Further Interactions

SFTR

- Addresses the identified lack of transparency in the use of securities financing transactions ('SFTs')and aims to prevent banks and other financial intermediaries from trying to circumvent banking regulation by shifting parts of their activities to the less-regulated bank-like credit intermediation
- Provides for reporting and disclosure requirements in relation to SFTs to better enable national regulators and the ESRB to assess and monitor systemic and shadow banking risks. Responses to ESMA DP on reporting framework published 03.05.2016

MiFID II

Key aspects of MiFID II that will have an effect on AIFMs:

- Unbundling/ Payments for Research
- Product Governance
- Transaction Reporting
- Telephone Recording
- Greater Transparency on Best Execution

Market Abuse Regulation

- Entry into Application: 03.07.2016 – Majority of MAR will be law
- MAR will apply to a wider range of securities and derivatives admitted to trading on a broader range of markets
- FCA Thematic Review 'Asset management firms and the Risk of Market Abuse – lack of effective policies for the receipt of inside information

AIFMD II…?

2017 Review of AIFMD

AIFMD provides for a review of the Directive by the European Commission in 2017 – it should address the following:

- Application & Scope of AIFMD;
- Analyse the experience acquired in the application of the Directive;
- Has EU Harmonisation caused any on-going major market disruption;
- Does the Directive function effectively in light of the principles underlying the internal markets and the single rulebook for financial services;
- The effectiveness of the passport regime;
- The supervisory role of ESMA and NCAs.

Focus on Supervisory Convergence

ESMA Supervisory Work Programme

- A thematic study on the operation of home and host responsibilities under AIFMD and UCITS with a view to clarifying the respective responsibilities of the NCAs and promoting the smooth operation of the EU passports for marketing and management; this is a high priority in view of the significance for the delivery of a fully functioning and efficient Capital Markets Union;
- **European Commission**

EU regulatory framework for financial services –

The Commission is currently looking for empirical evidence and concrete feedback on:

- Rules affecting the ability of the economy to finance itself and growth;
- Unnecessary regulatory burdens;
- Interactions, inconsistencies and gaps;
- Rules giving rise to unintended consequences.

kpmg.ie

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AIFMD & Valuation

KEN OWENS

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Alternative Investment Fund Managers Directive

Valuation Challenges and Opportunities
April 2016

pwc

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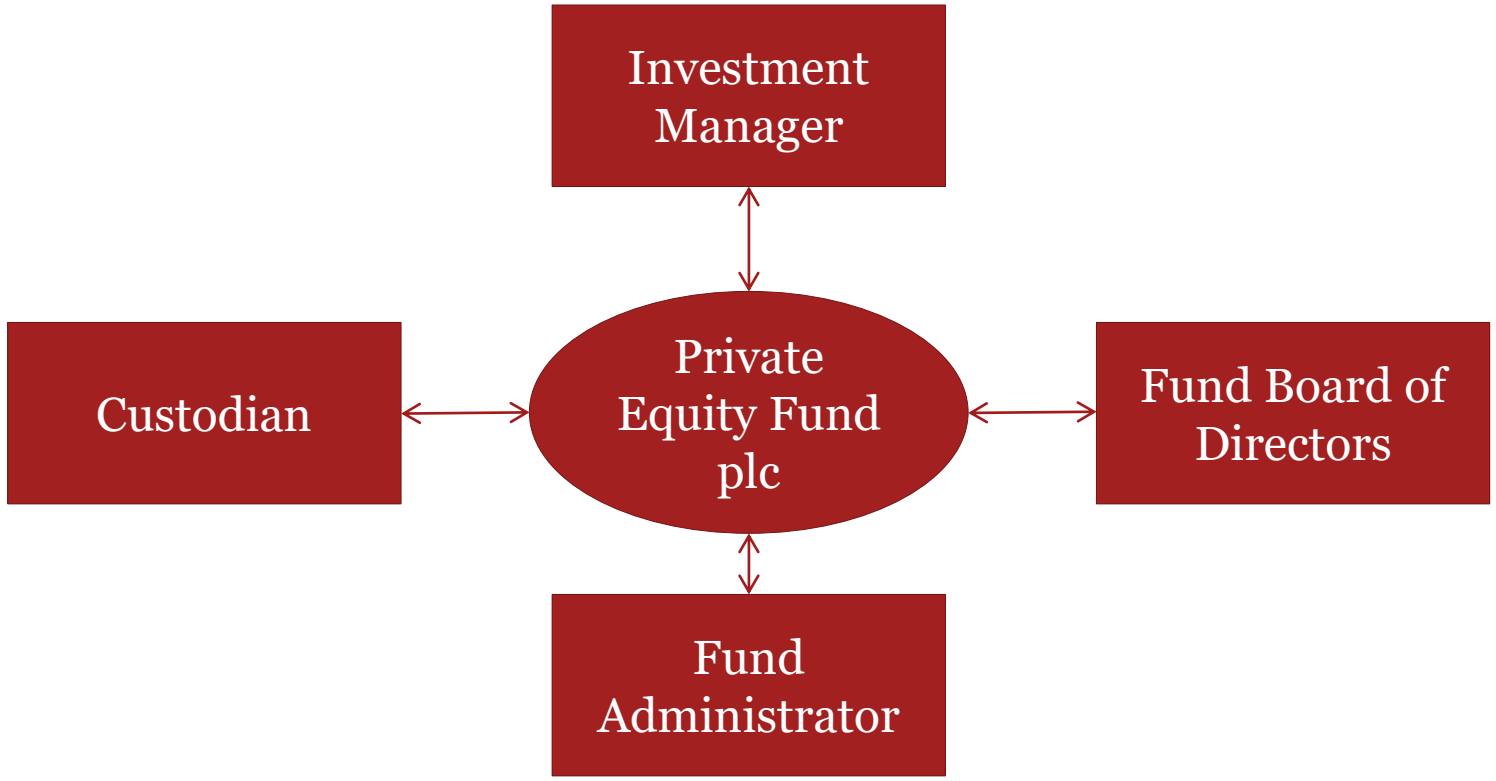
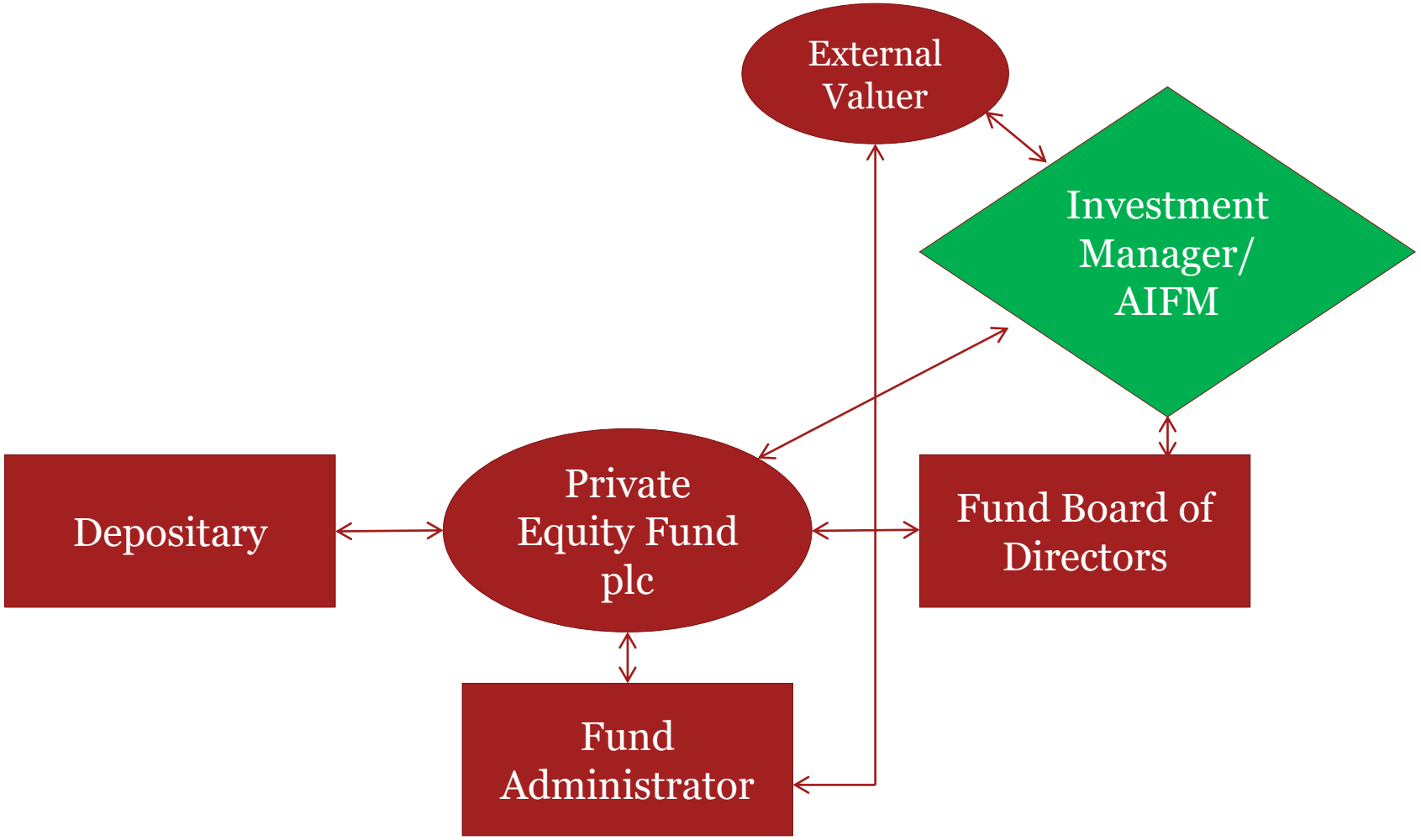

Investment Manager
Custodian
Private Equity Fund plc
Fund Board of Directors
Fund Administrator

Now.....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Investment Manager/ AIFM
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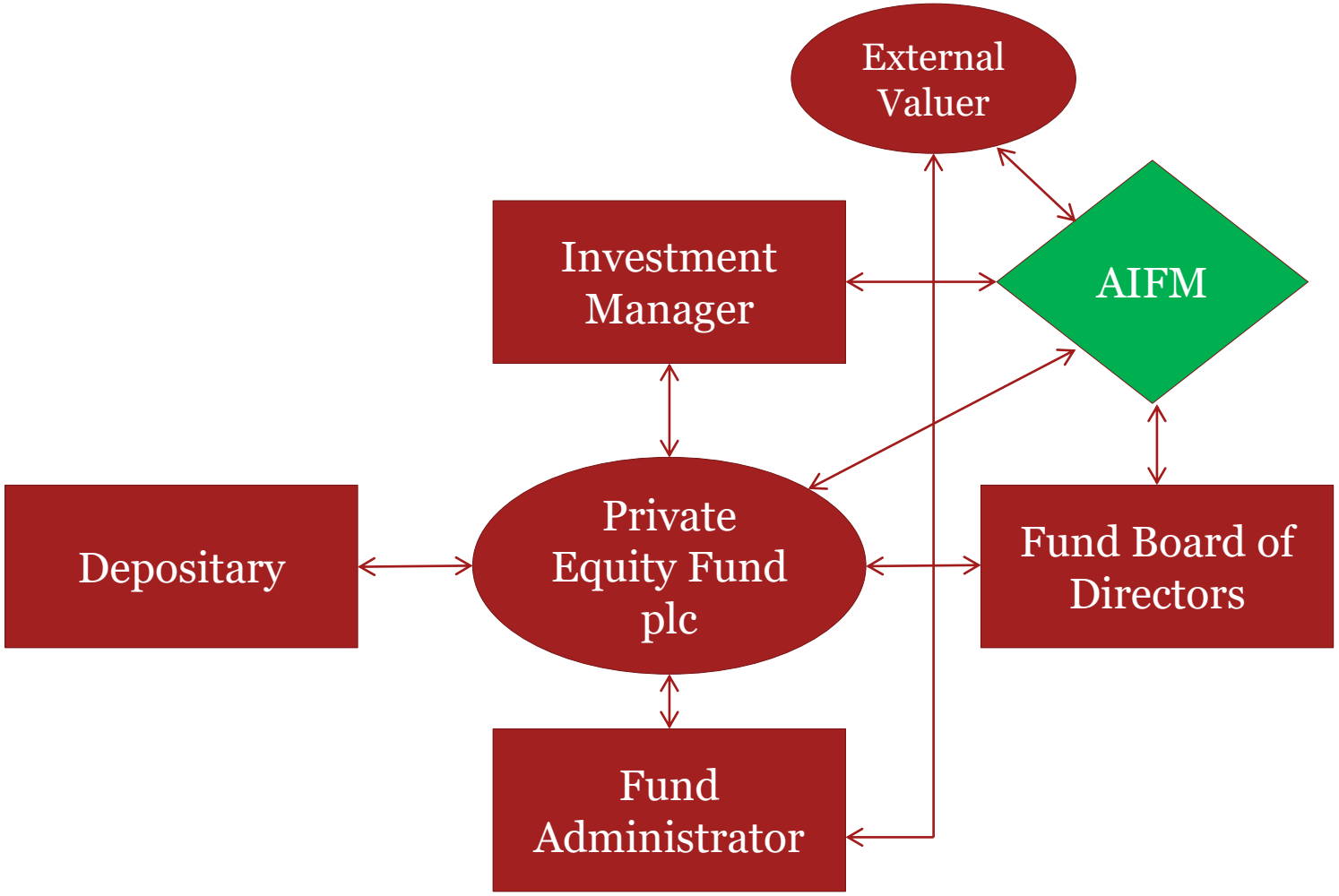
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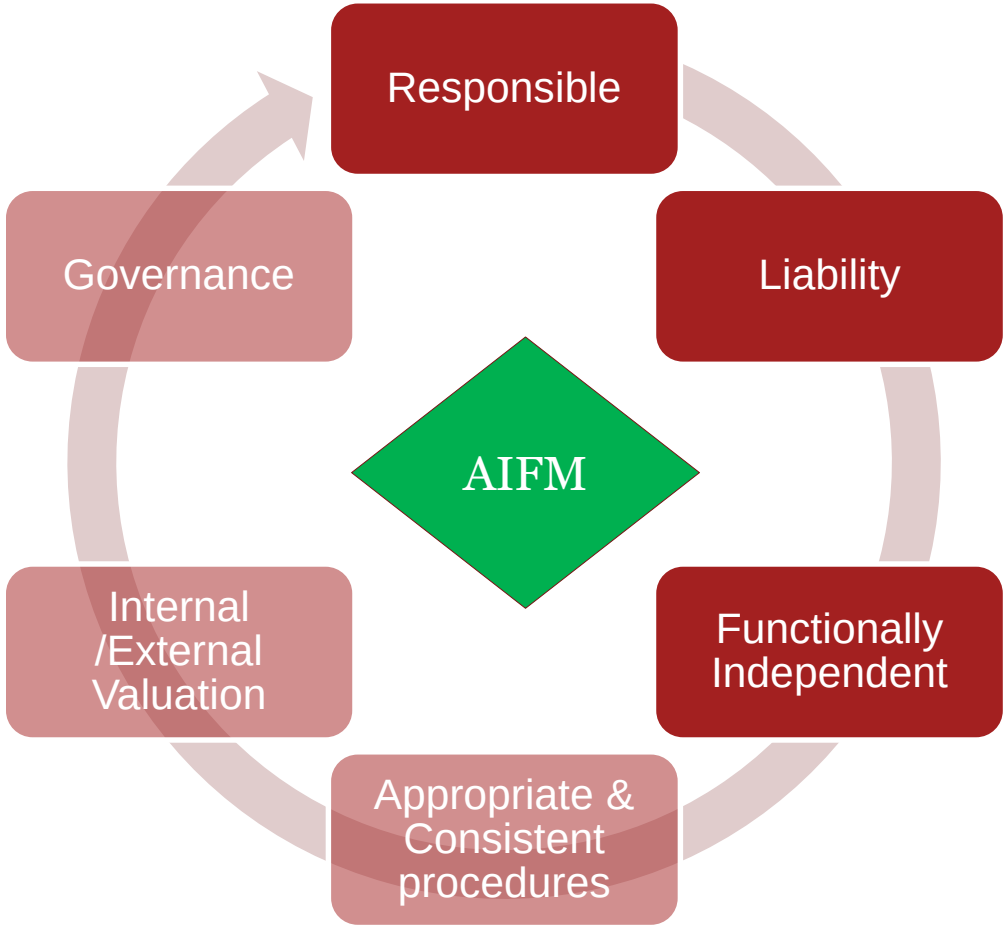
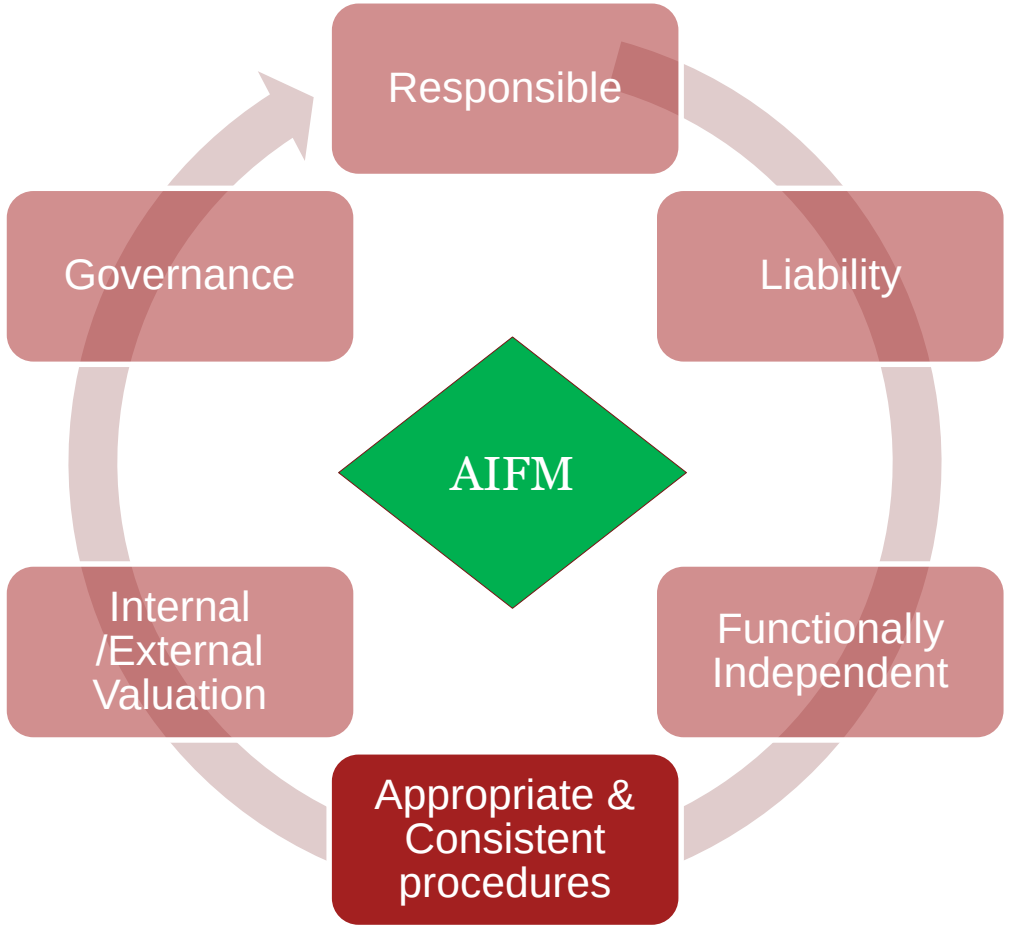
The Role of the AIFM in Valuation



The Role of the AIFM in Valuation



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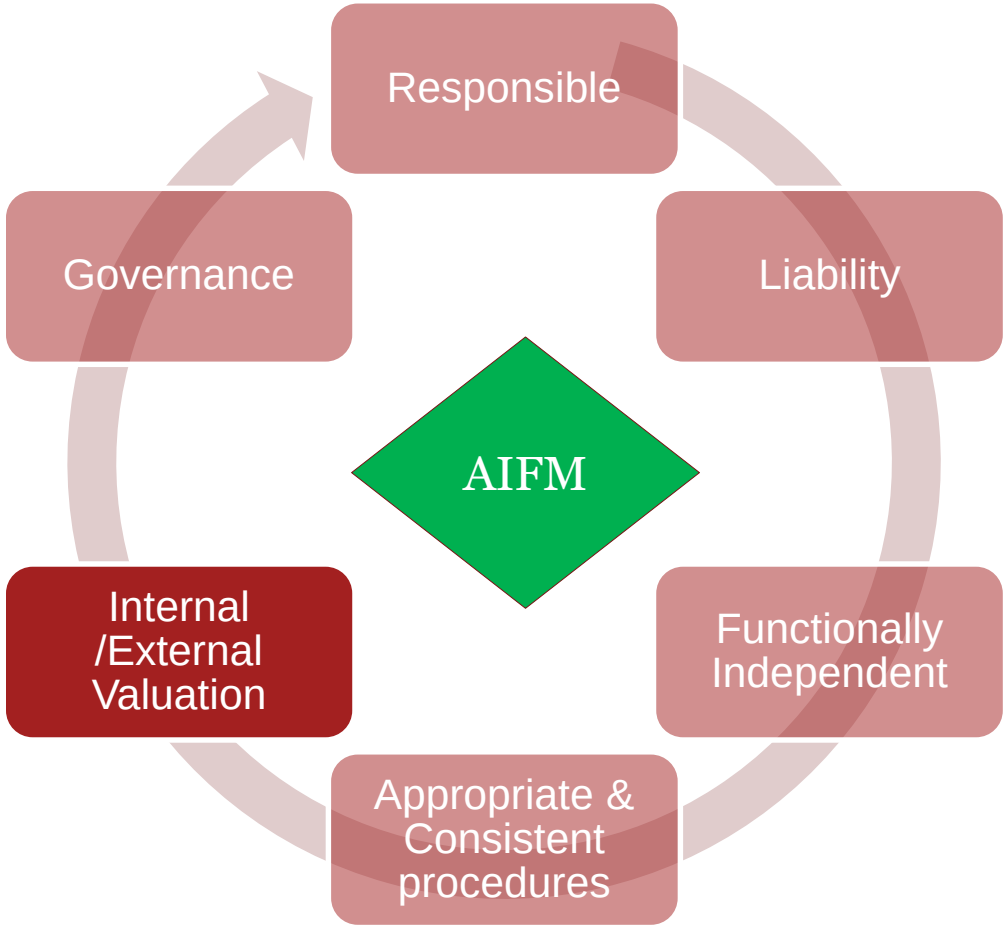
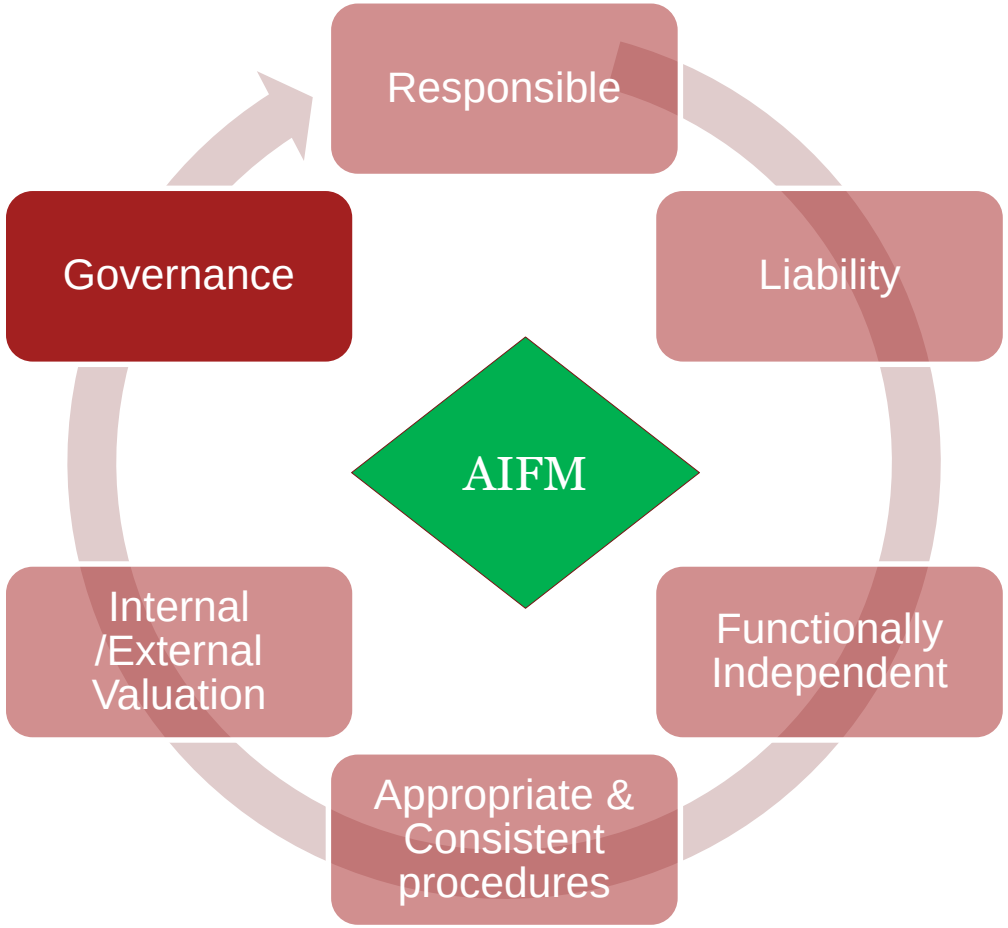
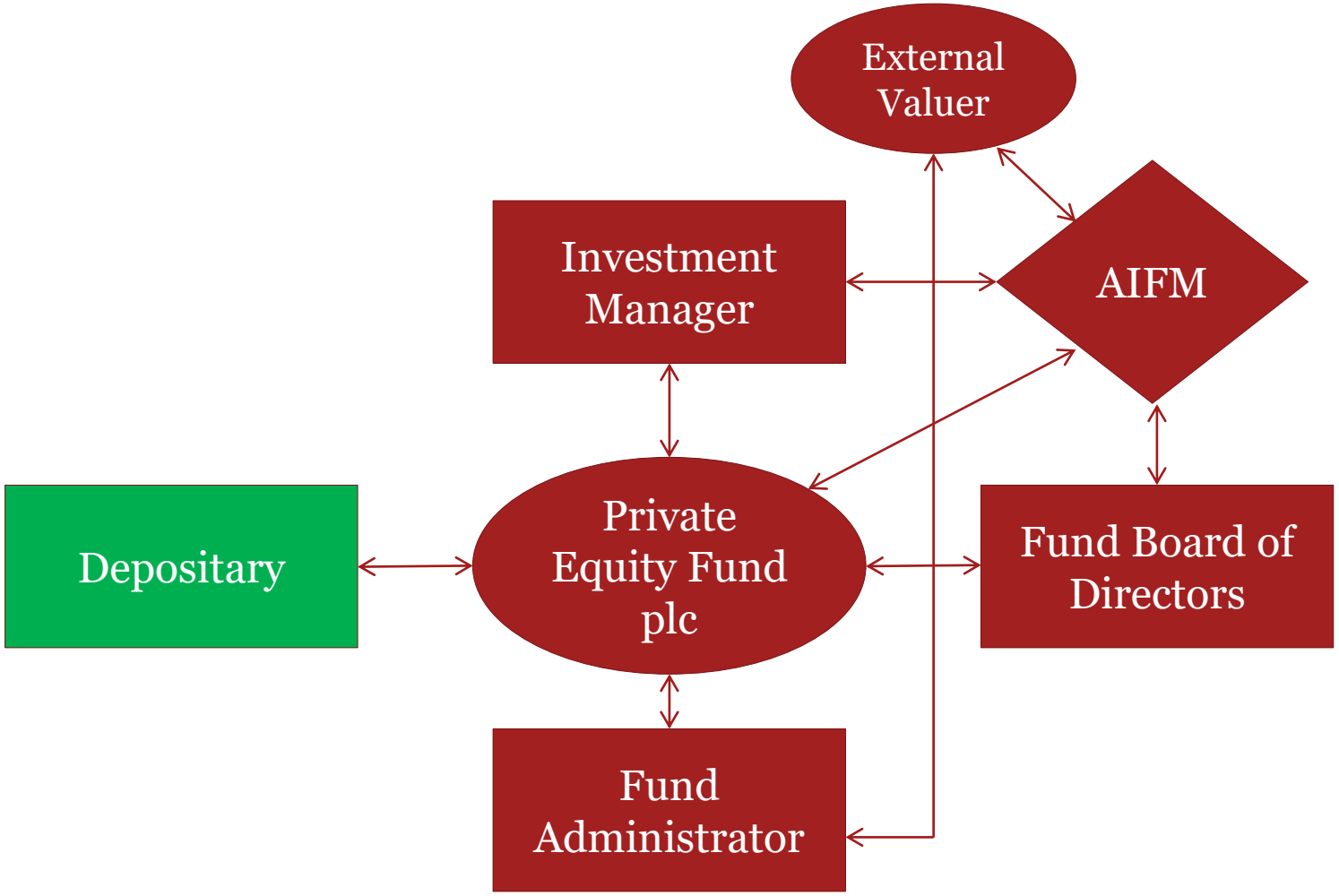


The Role of the AIFM in Valuation



Depositary's Role in Valuation..



So what are we seeing in our clients…..

Level 1

- Unadjusted
- Quoted prices for identical assets
- Active market

Level 2

- Quoted prices in inactive markets; or
- Values based on models – with observable inputs

Level 3

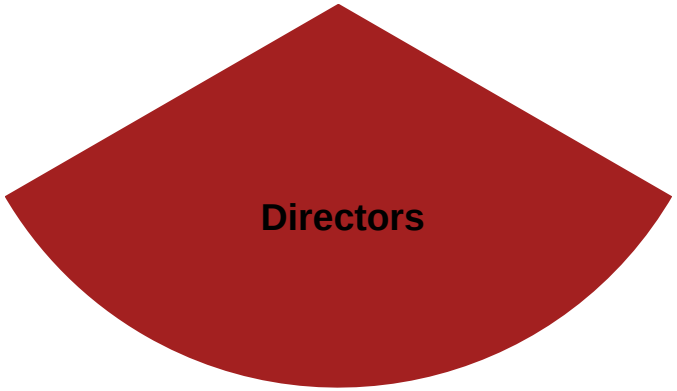
- Prices or valuation techniques
- Inputs that are both unobservable and significant.
- Valuations of these assets are typically based on management assumptions or expectations.

Areas for consideration by Managers

- Sufficient segregation of duties to take in-house?
- Evaluation of outsourced options
- Robust pricing policies and procedures
- Best in class valuation procedures
- Expectations of investors?

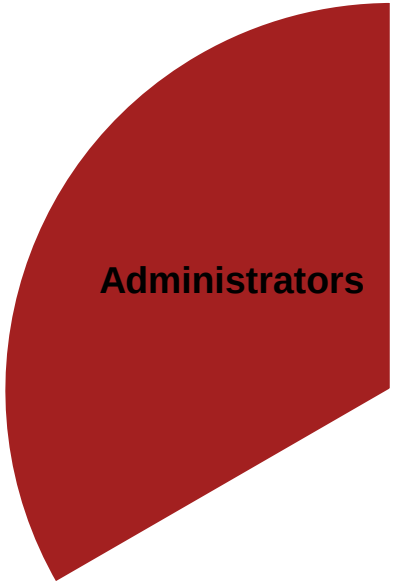
Areas for consideration by Directors

- Fiduciary responsibilities?
- Risk-based approach
- Valuation risks
- Valuation committee
- Reporting?



Areas for consideration by Administrators

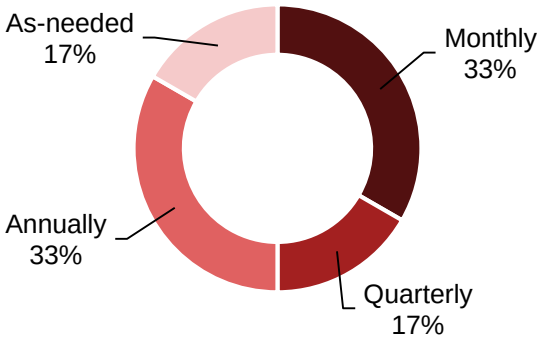
- External valuer role?
- Competitive position?
- Support services
- Depositary role



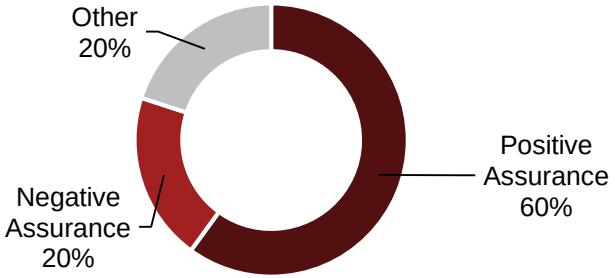
Example: Distressed loans…

Third Party Valuation Services

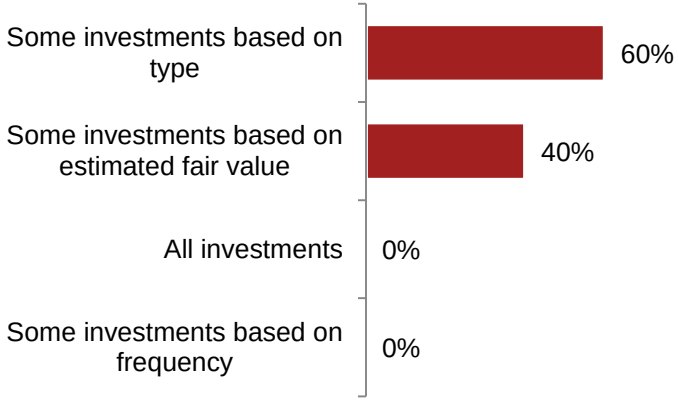
What is the frequency of valuation firm reviews/reports?



What is the nature of valuation reports received?



What investments does the third-party valuation firm review? (If applicable)



<u>Positive Assurance:</u>
A report that includes a determination as to whether or not the reviewer believes the valuation is presented in conformity with the applicable valuation framework.

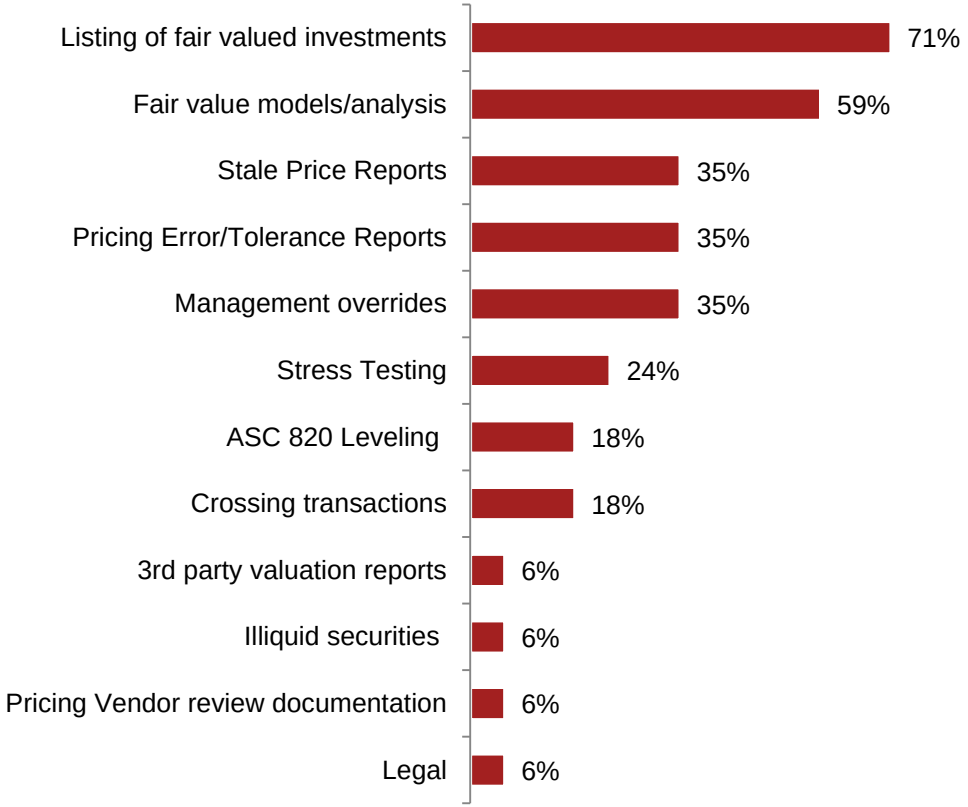
<u>Negative Assurance:</u>
A report that does not include an actual determination from the reviewer about the appropriateness of the valuations but states that they are not aware of any evidence to the contrary. (e.g. "We are not aware of material modifications that should be made to the valuations for them to conform with the applicable framework.")

Valuation Committee Composition

Which of the following groups are represented on the valuation committee? (Select all applicable)

Valuation Practices & Analysis

What analysis is provided to/reviewed by the valuation committee? (Select all applicable)



Does the valuation committee review and approve the valuation practices?

Thank You

Ken Owens

Partner

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Fund Valuation Under AIFMD

A SPECIALIST WORKSHOP FOR AIFM DIRECTORS, OFFICERS, ADMINISTRATORS, ACCOUNTANTS AND LEGAL/COMPLIANCE PROFESSIONALS

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AIFMD & The External Valuer

RYAN MCNELLEY

MANAGING DIRECTOR

DUFF & PHELPS

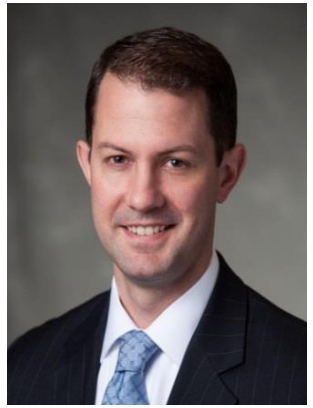
DUFF & PHELPS

Voltaire ADVISORS

6 May 2016

Ryan McNelley

Managing Director, Alternative Asset Advisory



Duff & Phelps, Ltd
London
+44 (0)20 7089 4822
Ryan.McNelley@duffandphelps.com

- ✓ Managing Director in the London office of Duff & Phelps
- ✓ 100% focus on the Alternative Investment Sector
- ✓ Work with both GPs and LPs on all valuation topics impacting the Alternative Investment Sector
  - Valuation Policies and Procedures
  - Valuation of underlying assets for NAV reporting
  - Valuation of Fund Interests, Carried Interest, etc.
  - Valuation documentation
- ✓ Valuation governance and the interest of the LP are always key focus

AIFMD and the External Valuer

The Role of the External Valuer in AIFMD Compliant Valuation

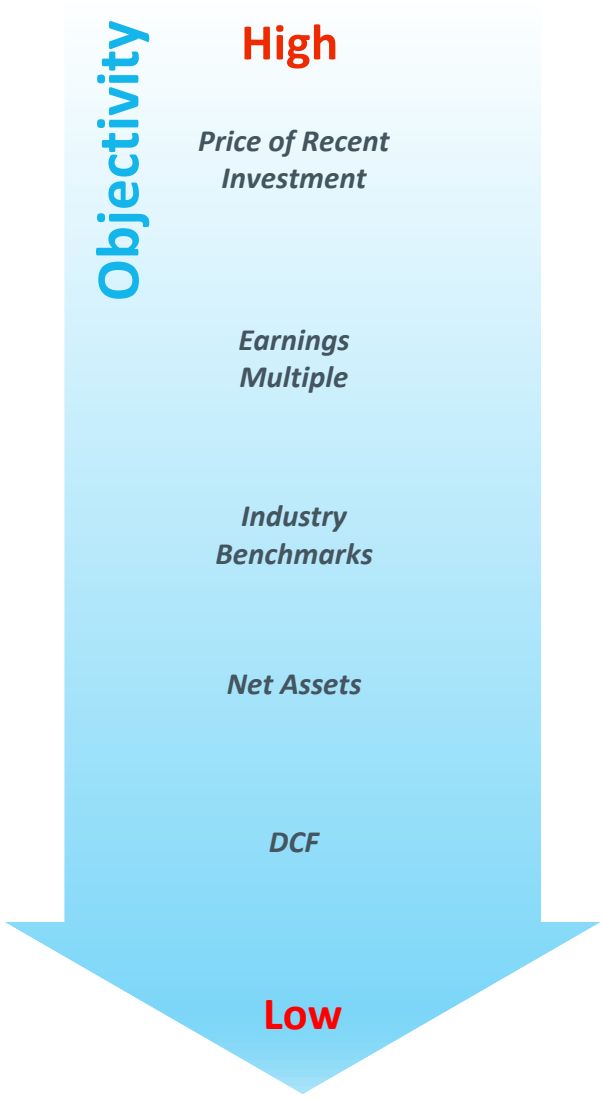
Ryan McNelley, Managing Director

Fair Value Defined

Fair Value is defined by:

"[T]he price that would be received TO SELL an asset or paid to transfer a liability in an ORDERLY transaction between market participants at the measurement date."

Valuation and Input Hierarchy



Level I Inputs

- ✓ Quoted prices
- ✓ Active Market

Level II Inputs

- ✓ Quoted prices for similar assets in active markets
- ✓ Bids in markets that are not active
- ✓ Inputs other than quoted prices that are observable
- ✓ Pricing service's reports for homogeneous securities

Level III Inputs

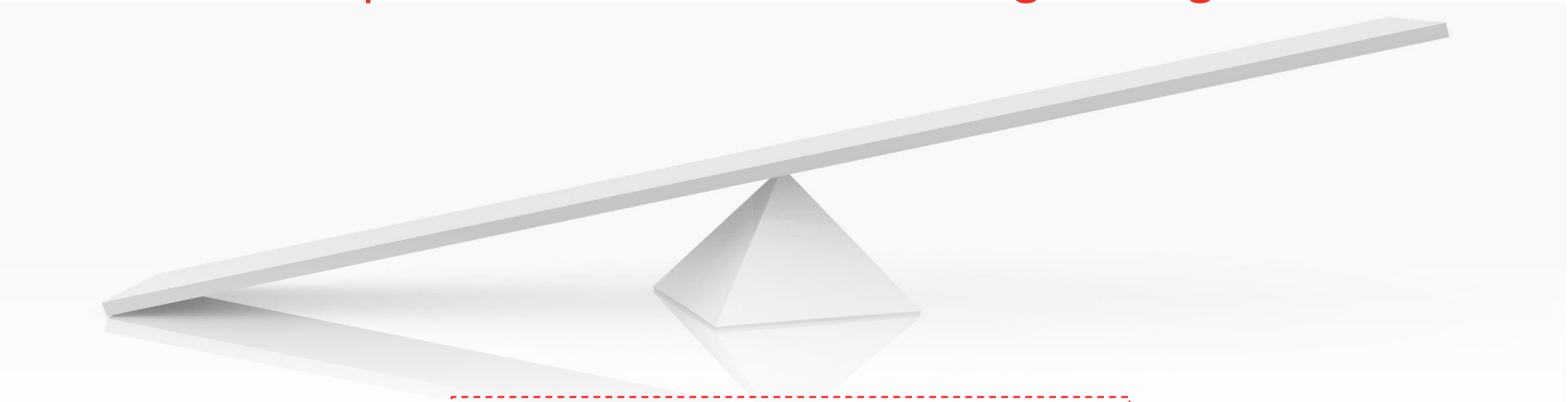
- ✓ Unobservable inputs for the asset or liability

AIFMD and the External Valuer

The Role of the External Valuer in AIFMD Compliant Valuation

Ryan McNelley, Managing Director

Robust and Independent Valuations – Striking the Right Balance



100% Deal Team Valuations

Valuations Performed by Deal Team Alone

- No in-house oversight
- Lack consistent approach (deal team by deal team)
- No independent validation of inputs or results
- No check on deal team bias (whether high or low)

The Right Balance

Valuation Performed with Input from the Deal Team but with measures taken to ensure / demonstrate Independence

- Valuations performed *with Deal Team input* are the most rigorous and robust.
- Management, being ultimately responsible for valuation conclusions, has a basis for their conclusion
- Demonstrating independence in the valuation process is required under AIFMD
- Independence can be demonstrated either through an enhanced internal process and/or through engaging a qualified, experienced Valuation Advisor to validate Management's Valuation Conclusions.

100% Independent Valuations

Valuation Performed Independently but with No Deal Team Input

- No-in-house oversight.
- Lacks consistent approach (third party to third party)
- Lacks input from those most knowledgeable (deal team)
- Does not eliminate responsibility from Fund Management

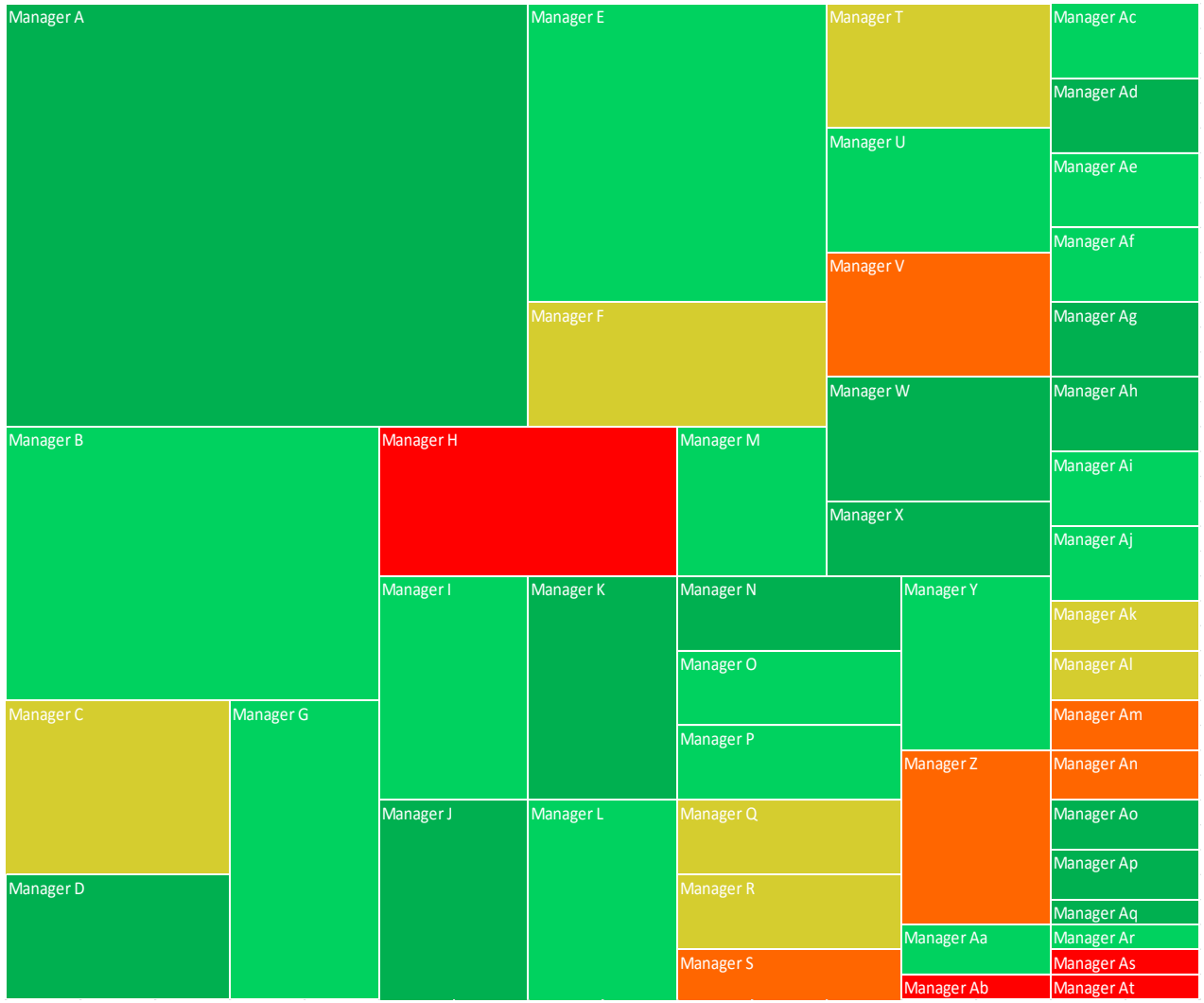
Alternative Investment Valuation – Best Practice

Weak

No understanding of GP's valuation process

Strong

Full understanding of GP's valuation process



QUESTIONS?

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Evaluated Pricing & Fund Valuation Requirements To Mitigate Risk and Regulatory Exposure

OZAN TUZUNALPER
DIRECTOR
THOMSON REUTERS

Valuation Requirements to Mitigate Risk & Regulatory Exposure

Ozan Tuzunalper
Market Development Manager
Enterprise & Risk Solutions

May 2016 - London

Agenda

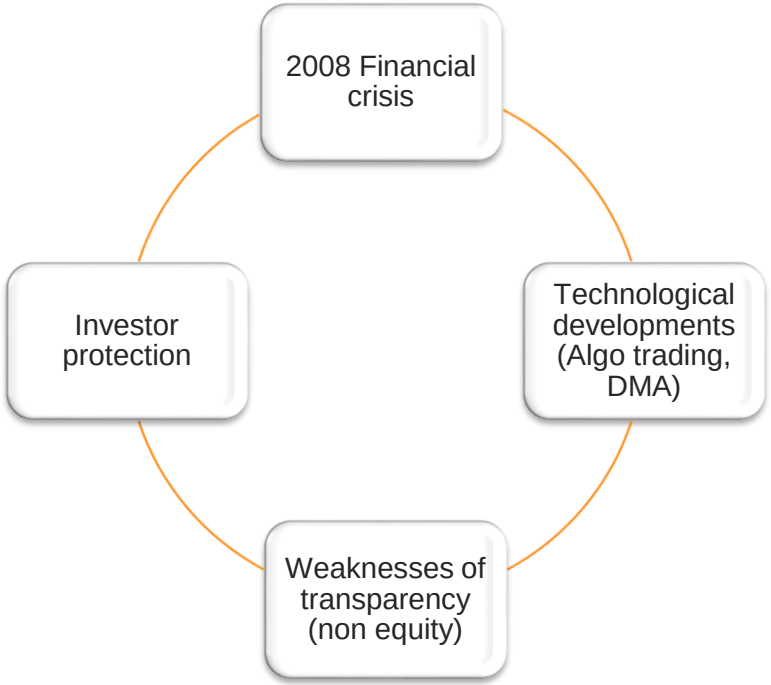
- Increasing Regulatory Pressure
- Regulatory Landscape & Common Themes
- Risk Management Workflows & Regulatory Reporting Requirements
- Commonalities of Regulatory Requirements
- 2016 Expectations & Beyond
- Usage of Independent Valuation
- What is an Evaluated Price?
- Why accurate valuation is important?
- Thomson Reuters Answer

What Drives The Market?

Key Drivers

At G20 summit in November 2008 leaders concluded that a secure and stable financial system requires financial markets to be subject to robust regulation and supervision.

Through improved transparency, simplification and more adjusted structure of financial services based on client types (non financial vs. financial)



Targeting to eliminate systemic risk and distortion probability of Blackpool and Algo trading through regulation of electronic trading platforms

Mainly targeting non-equity OTC trading associated risks through increasing transparency of pre-trade and post-trade phases of the workflow.

Risk Management Practises & Regulations

- Risk based valuation
- Sensitivities
- Position / collateral valuation
- Contingent liability management
- Scenario analysis
- Stress tests

Market Risk Management

Monitoring and managing exposure of loss associated to price/yield volatilities at different confidence levels and sensitivitie

Credit Risk Management

Monitoring and managing exposure of loss due to probability of default of counterparty/issuer to meet its obligations.

- Spreads
- Ratings
- Default Probabilities
- Country of Risk
- Concentration Risk
- Smart Ratios
- Sentiment Analysis

Operational Risk (Compliance Risk)

Monitoring and managing exposure of loss due to incompliance & unlawful conduct.

- Systems and processes around KYC
- Proactive compliance management
- Regulatory Intelligence
- Third Party Due Diligence
- Market Surveillance

Liquidity Risk Management

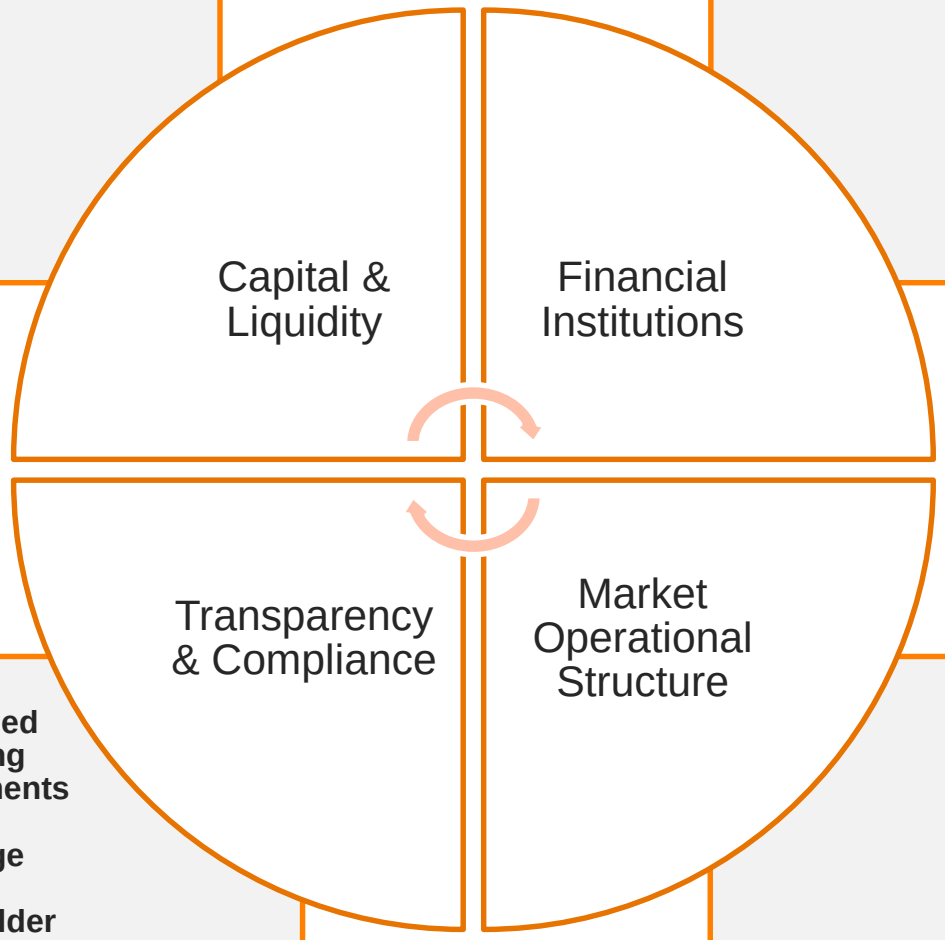
Monitoring and managing exposure of loss due to price inefficiency caused by lack of tradable turnover (availability to trade)

- Bid/Offer Spread
- Amount outstanding
- Number of price sources
- High-Low Volatilities
- HQLA Assessments
- Concentration of asset

Common Themes Of Regulations

- Strengthens financial institutions‘ capital adequacy and liquidity reserves to increase resilience of financial system. (Basel III, Solvency II)

- Reforming financial institutions structure of operations to protect investors and counterparties. (i.e. Volker Rule of prohibitions of prop trading)



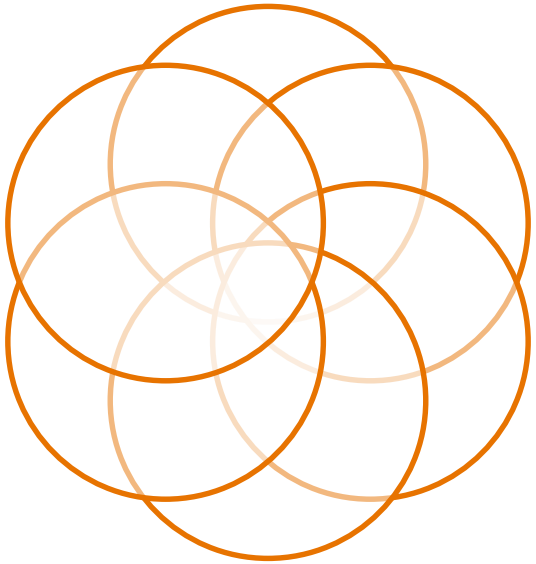
- Through establishing global standards, merged with post trade reporting requirements, governments are able to monitor, cooperate and exchange information on cross border basis. (Shareholder Disclosure)

- Mainly targeting derivatives markets through reducing risk and increasing transparency. (EMIR, Dodd-Frank, MiFIDII)

Common Asks

Risk based asset valuation: the 'know your assets'

Consistency: Data being used and reported for regulatory purposes should be consistent front to back office.



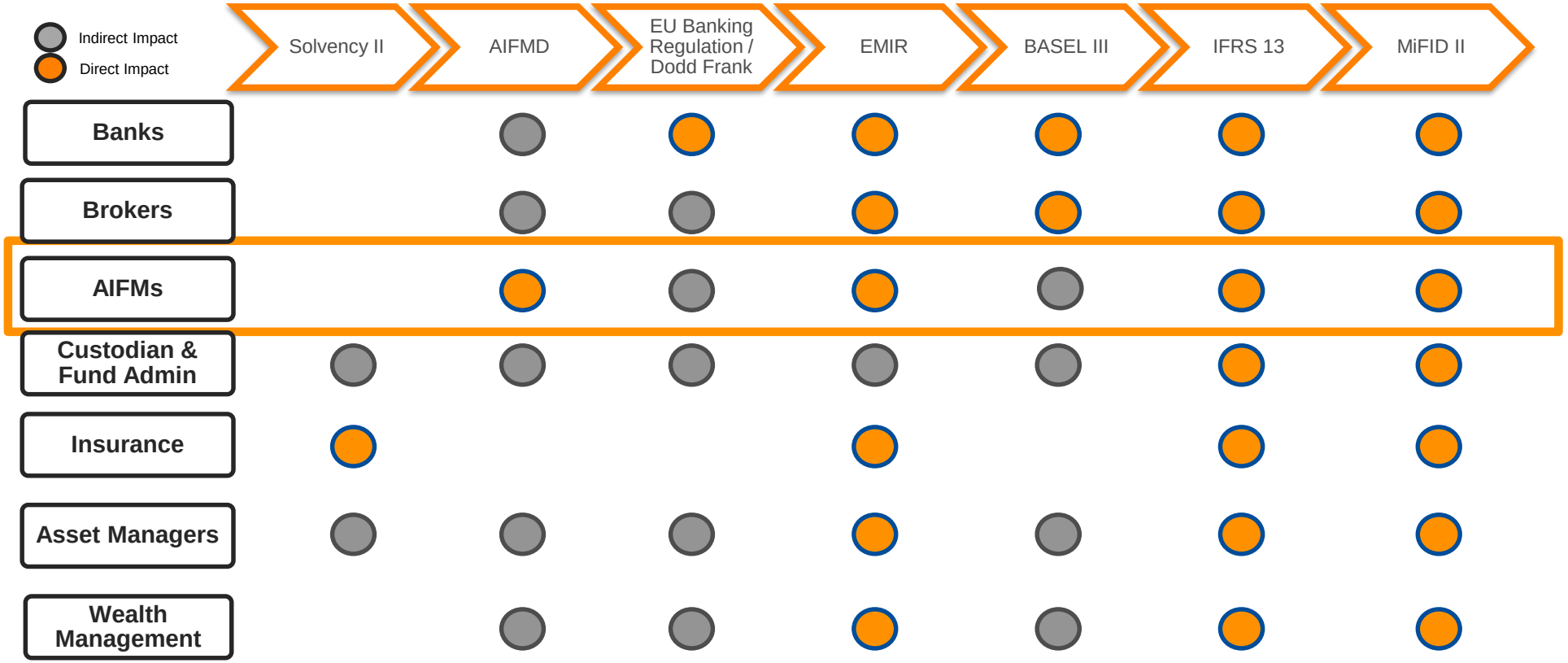
Asset classification & identification: with consistent standards of identification codes.

Transaction reporting: Including all descriptive information relating to each trade made by a firm over the course of a period (usually a day (T+1)).

Forward looking risk assessments: a need for long term discount and benchmark credit curves;.

Stress testing and sensitivities: fast and accurate crisis reporting to manage systemic risk.

Solving For Communities



Expectations for Asset Managers - 2016

- Data quality, completeness and accuracy will become central to every asset manager.
- Having one central repository of the financial data for the manager and related funds will be key
- Ensuring absolute completeness and consistency across all company workflows from front office to risk management and regulatory reporting.
- Reporting requirements are set to explode (FATCA, CRS, UK FATCA, EMIR, AIFMD, Dodd Frank, Solvency II, Country by Country Reporting, MIFID II, FTT reporting and investor and tax reporting…etc.)
- Ensuring that reported tax and regulatory information are consistent and drawn from the same data pool

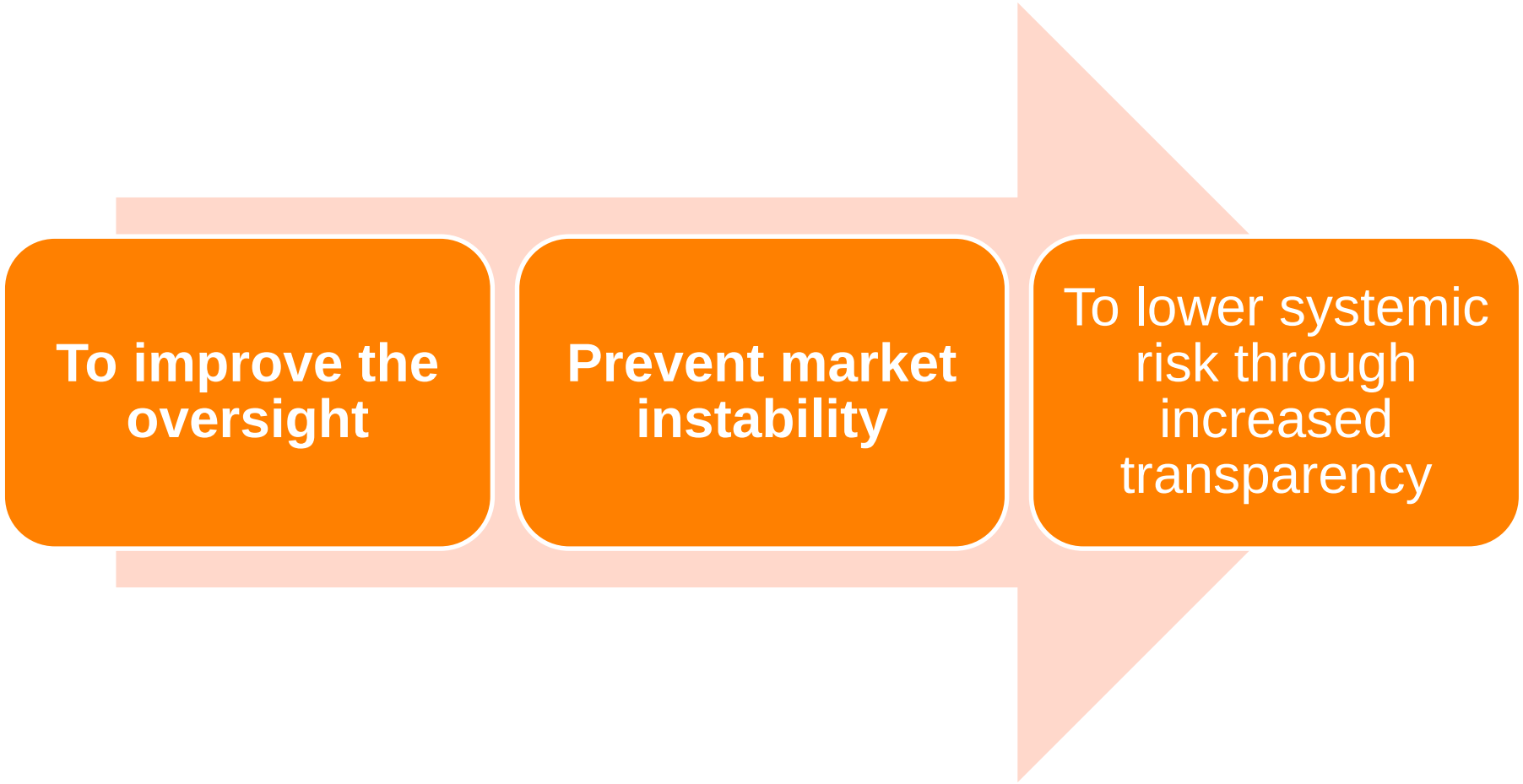
Usage of independent valuation

Fund managers particularly need a reliable and accurate assessment of portfolio risk in order to make fair value determinations.

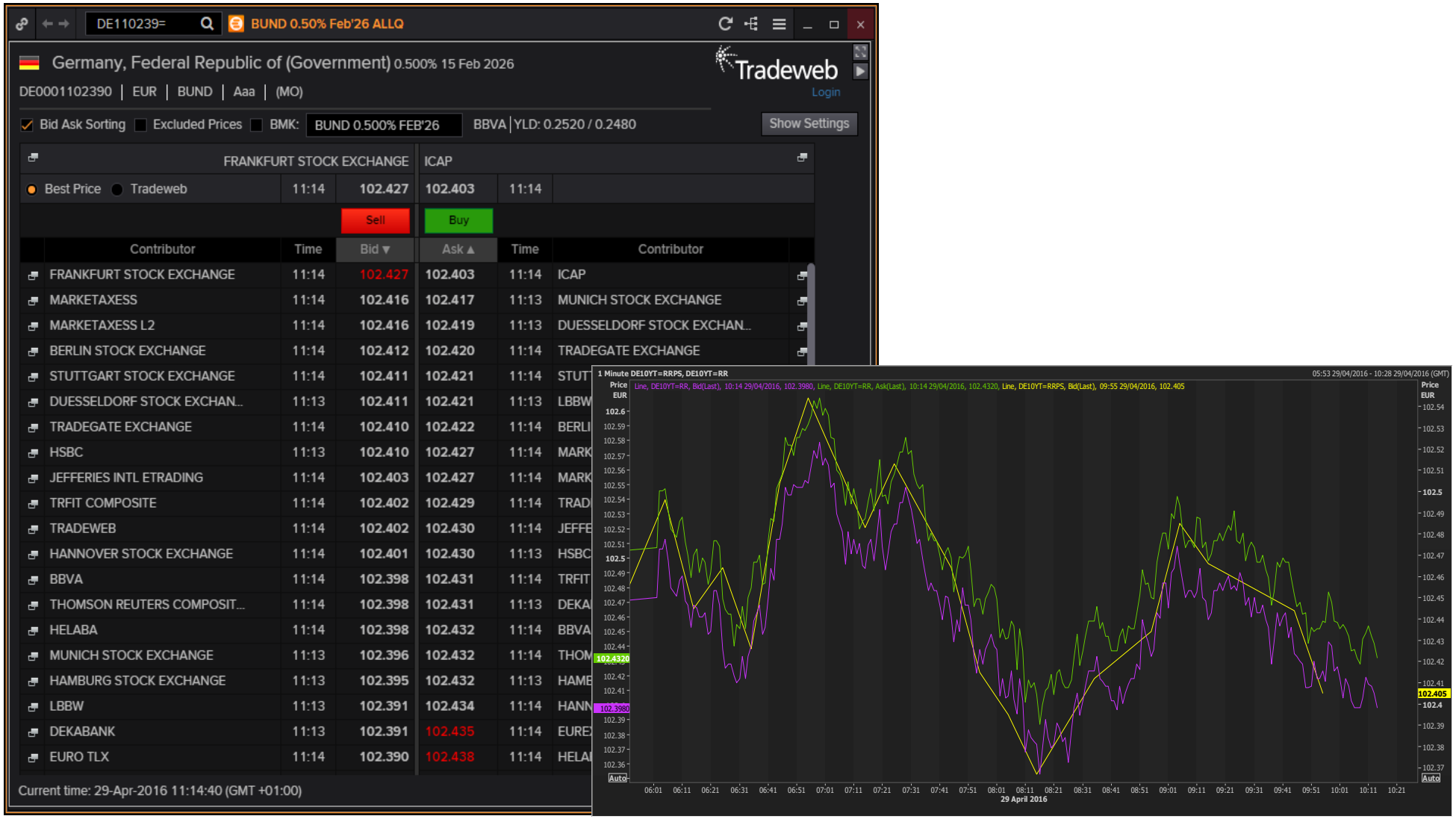
The AIFMD requires asset managers to use independent valuations for the alternative funds they manage

Why accurate market valuations?

Objectives of regulations



Germany 10 year Benchmark



Source: Thomson Reuters Eikon

Turkey 2040

US900123BG46 | TURKEY 6.75% May'40 All Quotes

Turkey, Republic of (Government) 6.750% 30 May 2040

US900123BG46 | USD | TURKEY | Baa3 | (MO)

Tradeweb Login

Bid Ask Sorting | Excluded Prices | BMK: GOVT 2.500% FEB'46 | TRADEWEB | YLD: 2.6961 / 2.6945 | Show Settings

	CARL KLIEM SA		STUTTGART STOCK EXCHANGE	
Best Price / Tradeweb	09:22	119.250	119.250	11:03

Contributor	Time	Bid (Sell)	Ask (Buy)	Time	Contributor
CARL KLIEM SA	09:22	119.250	119.250	11:03	STUTTGART STOCK EXCHANGE
THOMSON REUTERS SNAPSHOT	11:09	118.752	119.363	11:15	MARKETAXESS
TRFIT COMPOSITE	11:15	118.750	119.370	10:48	DUESSELDORF STOCK EXCHAN...
THOMSON REUTERS COMPOSIT...	11:15	118.722	119.383	11:15	TRADEWEB
FINANSBANK	07:39	118.720	119.450	10	
TRADEWEB	11:15	118.690	119.493	11	
BERLIN STOCK EXCHANGE	11:16	118.650	119.501	11	
MUNICH STOCK EXCHANGE	11:16	118.650	119.530	08	
TURKIE IS BANKASI	10:34	118.650	119.600	11	
DENIZBANK	11:15	118.625	119.600	11	
MARKETAXESS	11:15	118.613	119.600	10	
STUTTGART STOCK EXCHANGE	11:03	118.600	119.625	11	
YAPI KREDI BANK	08:53	118.470	119.720	07	
DUESSELDORF STOCK EXCHAN...	10:48	118.190	119.750	11	
FRANKFURT STOCK EXCHANGE	10:00	117.650	120.000	09	

Current time: 29-Apr-2016 11:16:23 (GMT +01:00)

Source: Thomson Reuters Eikon

Challenge is accurate validation of value….

Source: Thomson Reuters Eikon

What is an evaluated price?

AN EVALUATED PRICE:

Professional opinion of the market value / fair value of a financial instrument at a specific point in time.

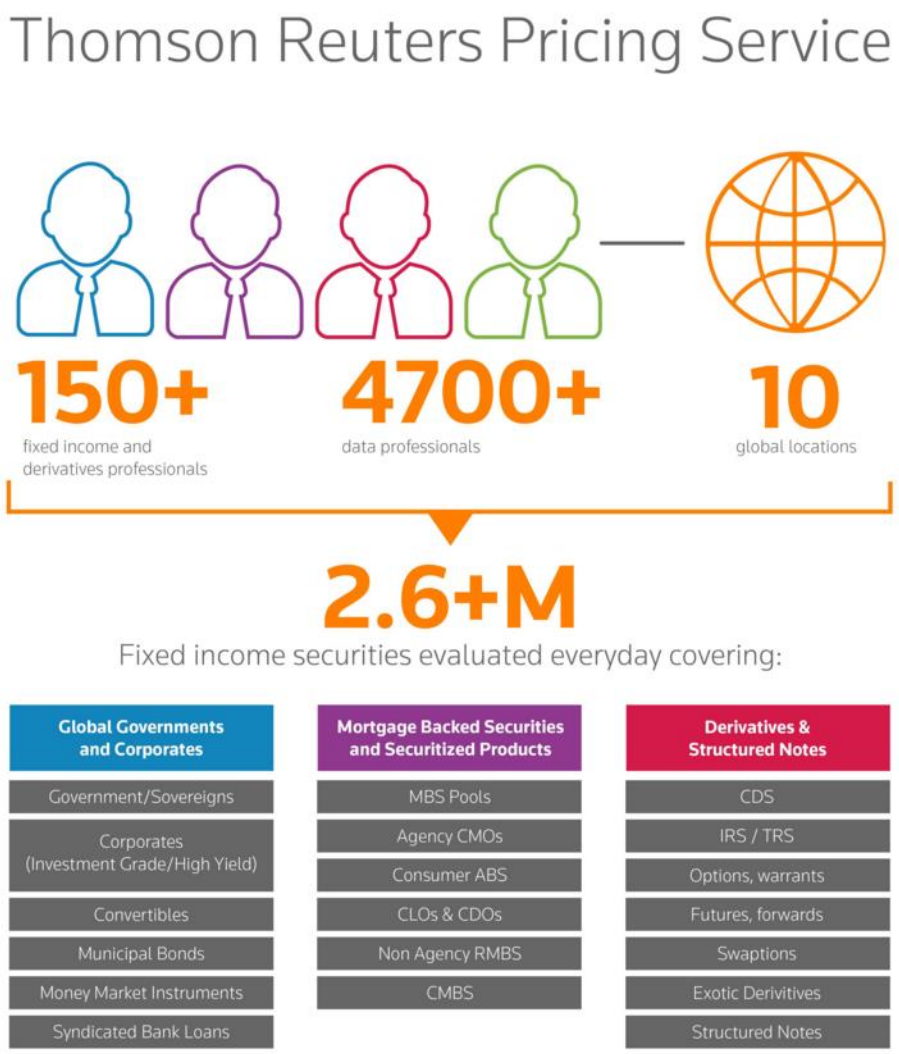
Current and Accurate	Prices are updated daily
Independent	Unbiased and accurate
Consistent Methodology	Up to date and aligned to market convention
Transparent	Full methodology and market inputs are shared
Price Challenge Process	User friendly platform, evaluators are always available
Quality Assurance	Strict quality controls and a SOC 1 Type 2 in place for 15 asset classes

Thomson Reuters Evaluated Pricing Services

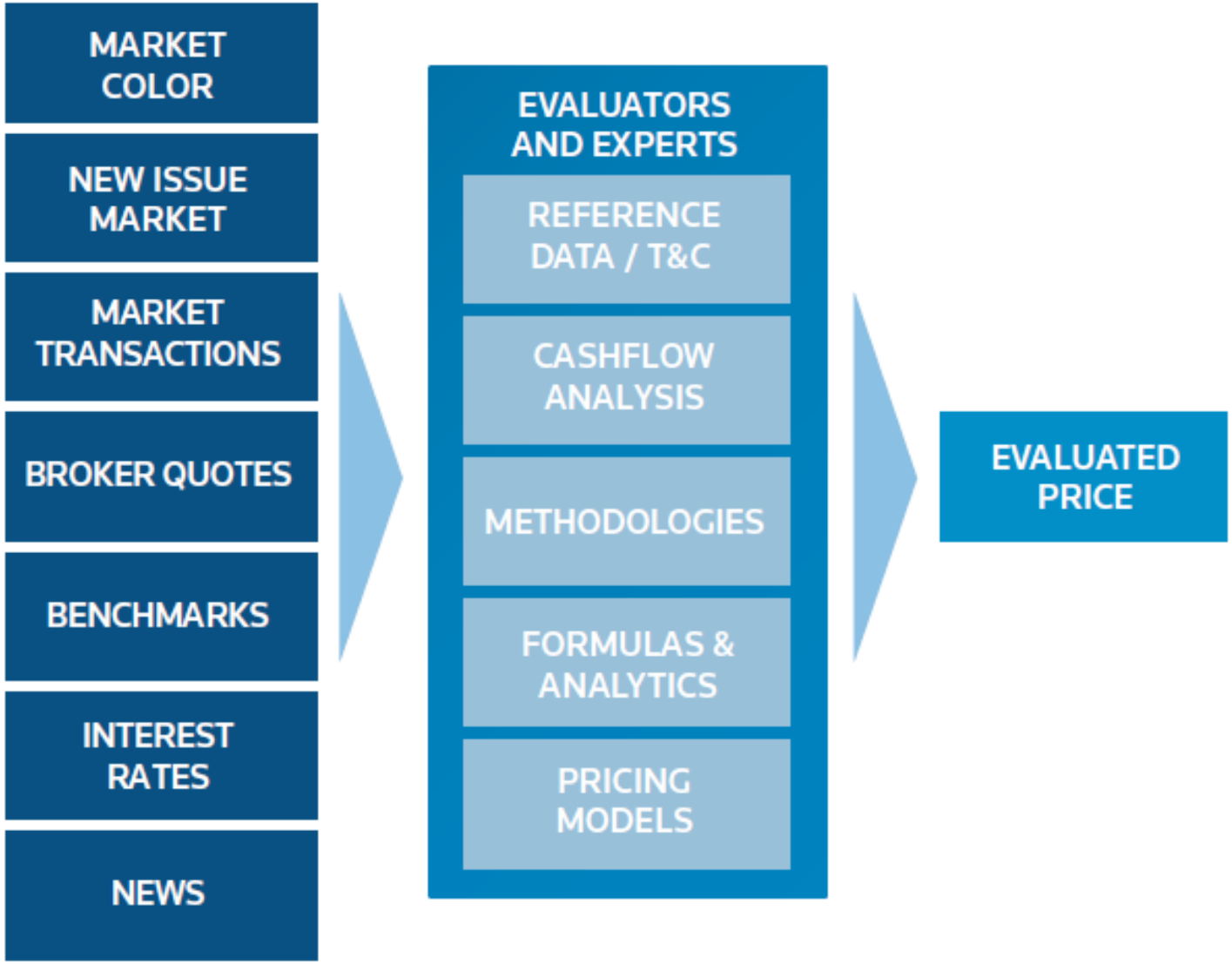
Thomson Reuters Pricing Service (TRPS) is an independent, global evaluated pricing source covering all major financial markets and prices available at multiple times daily.

1000s of issuers with more than 8 million securities are priced on cross asset basis.

2.6 million fixed income instruments, from plain vanilla products to complex structured derivatives are covered by TRPS.

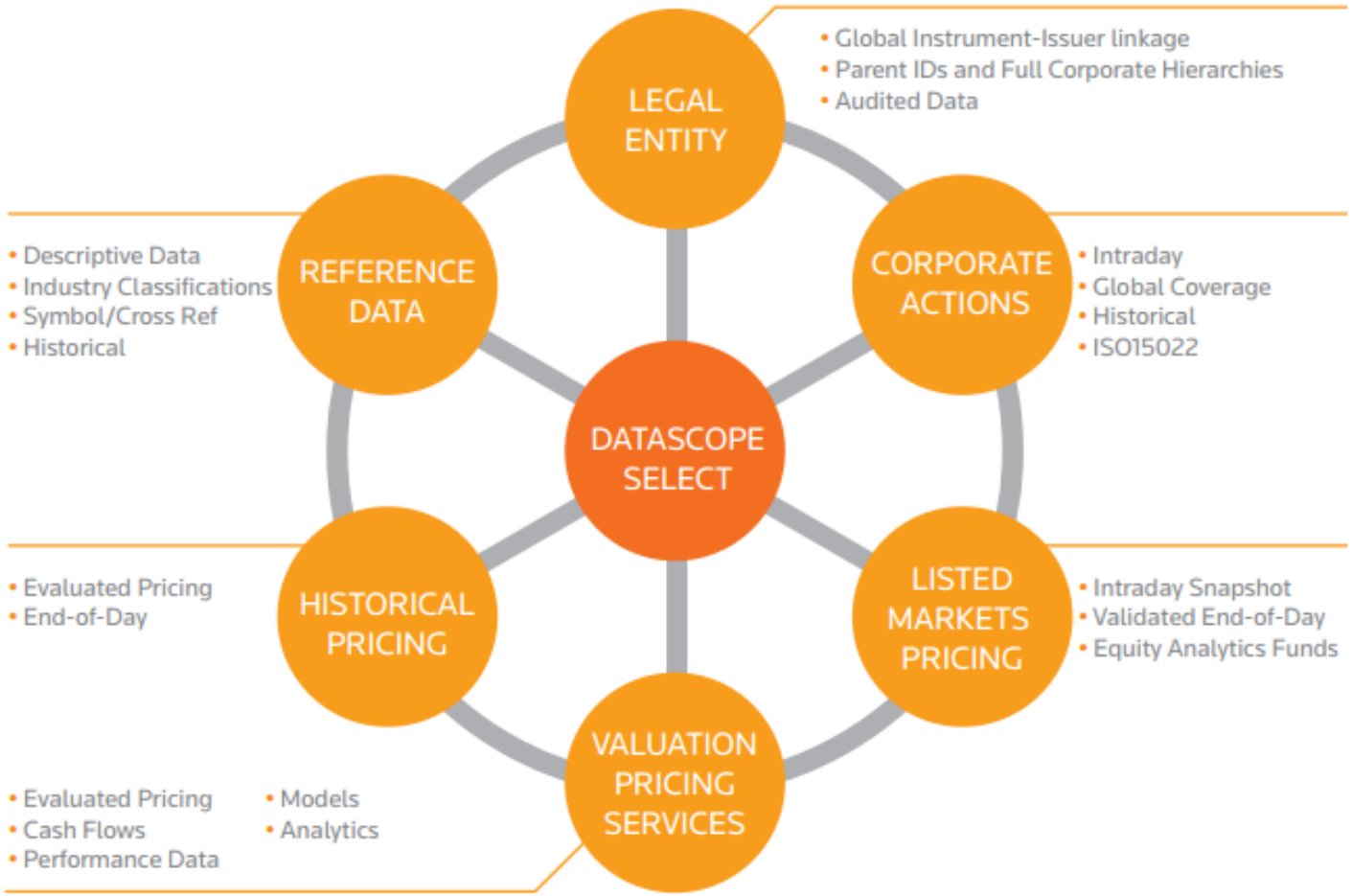


Independent, Transparent and Accurate Valuations



Best In Class

Ensuring Absolute Completeness & Consistency



Thank You!

Ozan Tuzunalper
Europe Market Development Manager
Enterprise and Risk Solutions

Voltaire ADVISORS

AIFMD & Vendor/Model Risk

IAN BLANCE
MANAGING DIRECTOR
VOLTAIRE ADVISORS

Vendor Risk

Voltaire ADVISORS

The valuation policies and procedures shall ensure that the AIFM conducts initial and periodic due diligence on third parties that are appointed to perform valuation services.

Article 67 – AIFMD Delegated Act

- Due diligence of third party vendors in addition to ODD
- SEC specifically requires this and makes it obligation of board
- BNY Mellon / Sungard
- Cybersecurity

Model Vendor Due Diligence

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- **Independence** - Due diligence should be independent of both the fund, the adviser and the vendor
- **Detailed Process Review** - Analysis and review of the underlying procedures, methods, sources, documentation, etc. and these should be periodically revisited to ensure their continued appropriateness and effectiveness.
- **Source Review** - Line by line review of methods/sources per position (since there can be wide variations within asset classes - simply stating that X vendor is used for all fixed income pricing is not sufficient). Again, these should be periodically revisited to ensure their continued appropriateness and effectiveness
- **Metrics** - The position review should include detailed empirical data on key metrics such as vendor overrides, price challenges, challenge results, stale prices, tolerance breaks, comparisons of valuations with trades, alternative prices (if available), etc.
- **On Site Due Diligence** - If a vendor is used for pricing, then there should be regular and detailed due diligence of their operations, processes, procedures, etc.

Model Validation

The valuation policies and procedures shall ensure that before being used a model is validated by a person with sufficient expertise who has not been involved in the process of building that model.

Article 68 – AIFMD Delegated Act

- Methods of model validation
- Parallel Implementation
- Convergence & Stress Tests
- Partial Differential Equation (PDE) Test
- Market Results / Hedge Correctness

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Fund Valuation Under AIFMD

A SPECIALIST WORKSHOP FOR AIFM DIRECTORS, OFFICERS, ADMINISTRATORS, ACCOUNTANTS AND LEGAL/COMPLIANCE PROFESSIONALS

Afternoon Agenda

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- 1300 **KEYNOTE: The Importance of Standards in Hedge Fund Valuation** – Olwyn Alexander, PwC
- 1330 **Panel Discussion - AIFMD & the Administrator**
  - Stuart Martin, Dechert | Richard Frase, Dechert | Ian Headon, Northern Trust
- 1415 **AIFMD & Regulatory Reporting** – Chris Farkas, Deloitte
- 1445 **Coffee**
- 1515 **AIFMD & Valuation Policy** - Ian Blance, Voltaire Advisors
- 1545 **AIFMD & Operational Due Diligence** – Jerome Lussan, Laven Partners
- 1615 **Panel Discussion - Valuation Oversight & Fund Governance**
  - Simon Osborn, IFI Global| Aymeric Lechartier, Carne Group | Chris Hilditch, Schulte Roth & Zabel | Richard Perry, Simmons & Simmons
- 1700 **Wrap Up & Close of Workshop**

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KEYNOTE

The Importance of Standards in Hedge Fund Valuation

OLWYN ALEXANDER
GLOBAL HEAD OF ALTERNATIVES
PWC

www.pwc.ie

The importance of standards in Hedge Fund Valuation

Olwyn Alexander

PwC - Global Alternatives Leader

pwc

Overview

- What is fair value?
- The fair value perspective
- Standards – Why ?
- 4 Core Areas
- Major Events 2007 - 2013:
  - AIFMD
  - Transparency
  - Side Pockets
  - Fair Value Hierarchy
- Valuation risks
- Hot topics

What is fair value?

What is fair value?

IFRS

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

US GAAP

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

SEC

The "value" of securities held by registered investment companies is the market value when market quotations are readily available. When market quotations are not readily available, a fund must use fair values, as determined in good faith by the fund's boards of directors, to value its portfolio securities and other assets.

FRS 102

Fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable,
willing parties in an arm's length transaction.

UK SORP

Fair value is normally determined by reference to quoted prices from reputable sources; that is the market price.

What is fair value?

AIMA

AIMA's Guide seeks to enhance sound practice principles for the fair valuation of hedge fund portfolios. Valuation procedures should be as consistent as possible with the chosen accounting standards of the fund.

MFA

A Hedge Fund Manager should establish a comprehensive and integrated valuation framework to provide for clear, consistent valuations of all the assets in the Hedge Fund's portfolio while mitigating potential conflicts that may arise in the valuation process.

IOSCO

The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.

HFSB

To ensure that the fund puts in place valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation.

IPEV

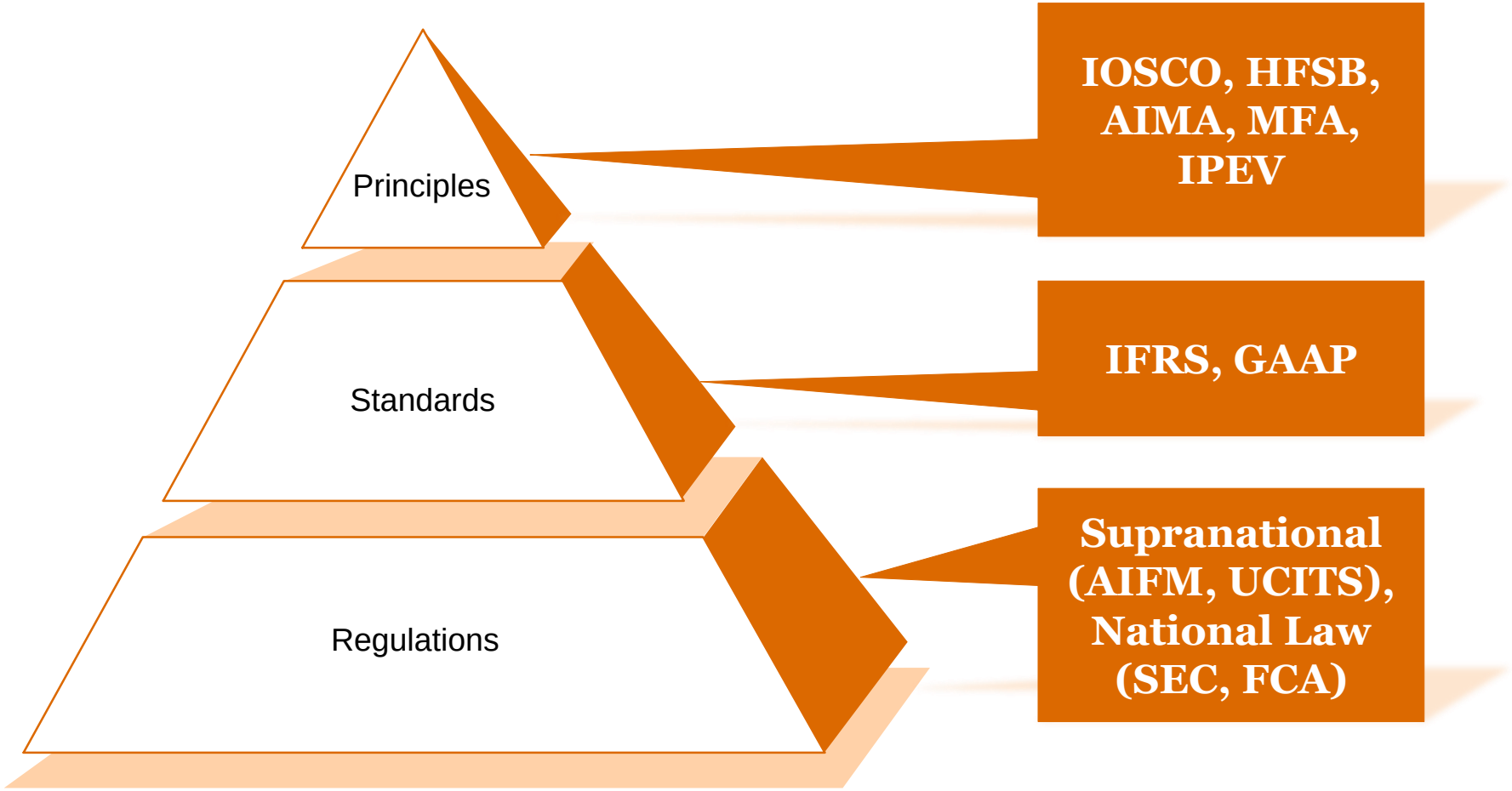
Discuses the "concept" of fair value being the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

AIFMD

Fair value not defined. The AIFM is responsible for the proper valuation of all assets and remains fully liable to the AIF and its investors.

The fair value perspective

The fair value perspective



Standards – Why?

Valuation Standards – Why ?

- AIMA :

  Original Guide – 2005

  Revised – March 2007

  Revised – June 2013
- IOSCO – 2007
- Self – Regulation
- Maturing Industry
- Demand from Investors
- What Value / Purpose served ?

4 Core Areas

4 core areas

- Governance
- Transparency
- Procedures, Processes & Systems
- Sources, Models & Methodology

Valuation principles - Governance

AIMA

- Valuation Policy Document
- Segregation of duties & Valuation Service Provider
- Controls over conflicts of interest
- Governing body

IOSCO

- Comprehensive, documented policies and procedures for the valuation of financial instruments
- Independence (i.e. third-party pricing services, independent reporting lines with the Manager, valuation committee)
- Governing body

HFSB

- Valuation arrangements aimed at addressing and mitigating conflicts of interest
- Recommends appointing third party valuation service provider
- Segregation of duties

MFA

- Comprehensive and integrated valuation framework
- Clear, consistent valuations
- Governance mechanism
- Guidelines to elevate exceptions
- Guidelines to test and review compliance with policies and procedures
- Independent personnel

Valuation principles - Transparency

AIMA

- Offering Document
- Details of Investment Manager involvement in pricing investment positions or NAV calculation
- Valuation policies and regular NAV reports to be made available for investors

IOSCO

- The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.

HFSB

- The Valuation Policy Document should be made available to investors
- Where a hedge fund manager is involved in the valuation process this should be disclosed

MFA

- Not specifically addressed

Valuation principles – Procedures, Processes & Systems

AIMA

- Fund's valuation process segregated from the investment process
- Sufficient documentation for Investment Manager involvement
- Procedures must be capable of practical implementation
- Consistent application of policies, any deviations should be approved

IOSCO

- Consistently valued according to policies and procedures
- Reviewed periodically to ensure continued appropriateness
- Independent review
- Documented procedures for handling price overrides
- Governing body to perform due diligence

HFSB

- Identify the role of parties involved in the valuation process
- In-house valuation
- Independent review by fund governing body or its valuation committee
- Refers to the AIMA Guide and IOSCO Principles for further guidance on the valuation of hard-to-value assets

MFA

- Identify the parties engaged in the valuation process
- Identify the appropriate methodologies to be used in valuing various types of investments
- Establish appropriate internal documentation procedures to support the valuation for each type of asset

Valuation principles – Sources, Models & Methodology

AIMA

- Valuations should be checked against a primary and secondary source.
- Hierarchy of sources & tolerance level for variances
- Where broker quotations are used they should, be multiple, sourced consistently, assessed independently and based on actual transaction data where possible
- Alternative valuations
- Side-pocketing of illiquid and/or hard-to-price investments

IOSCO

- The policies should identify the methodologies that will be used for valuing all of the financial instruments held

HFSB

- Offering documents should detail investment strategies and techniques employed

MFA

- Methodologies should include sources of prices for different types of investment positions
- Procedures for side-pocket investments
- Procedures for material exceptions

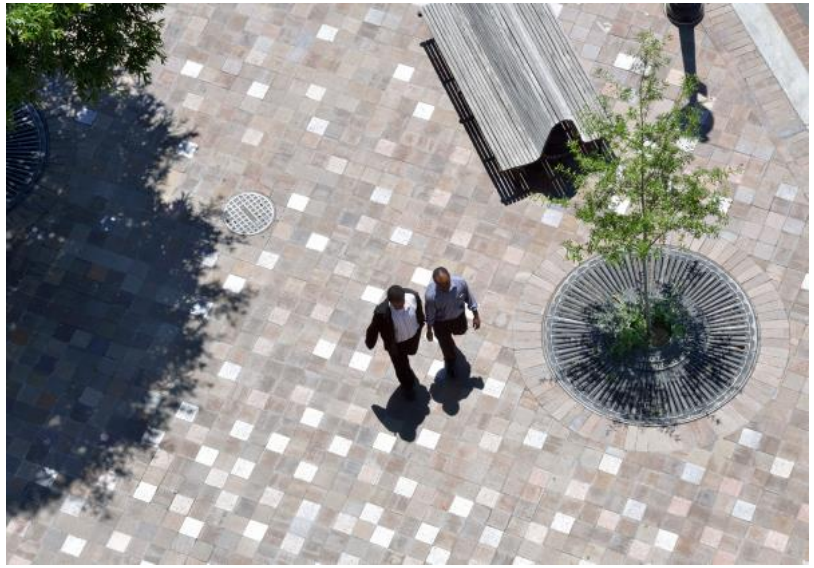
Major Events 2007 - 2013

AIFMD

- Concept of “Valuer”
- Guide Vs AIFMD re responsibility
- Guide Vs AIFMD re processes, procedures, documented procedures
- Overall message – Regulation must take precedence over voluntary code BUT
- Almost 100% consistency in the requirements

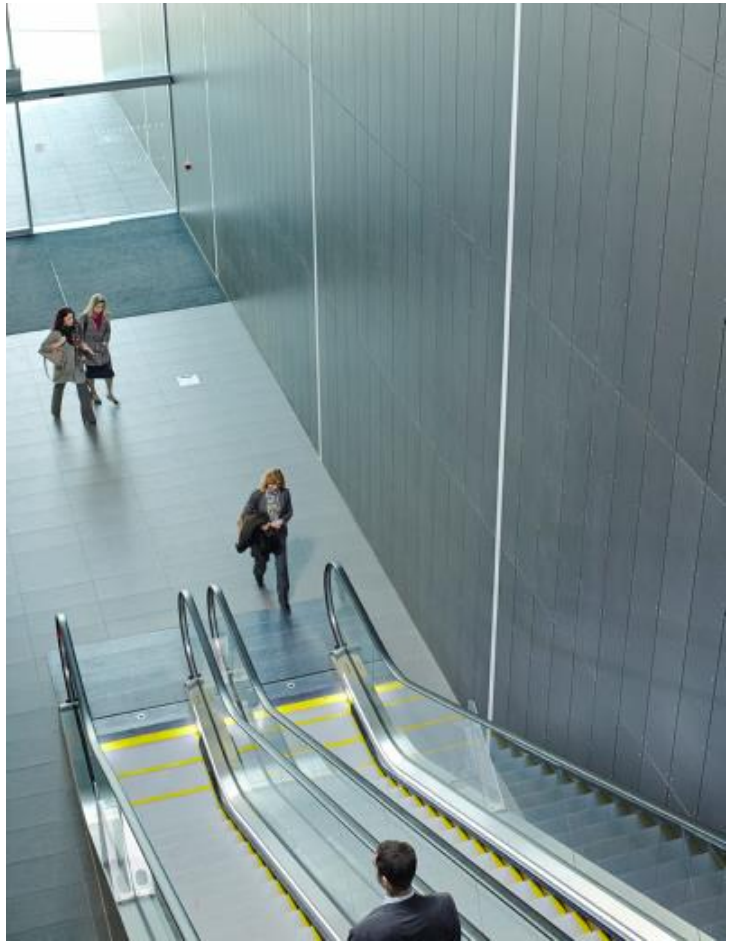
Transparency

- Growing Investor Demand
- Consultants pressure e.g. Opera
- Portfolio level, concentrations, valuation approaches
- Deeper dives by DD teams
- Most Administrators now producing



Side Pockets

- Much debate
- Role / Rights of the Manager
- Role / Rights of the Investors
- Fair Valuation should be performed frequently



Fair Valuation Hierarchy

- Recommendation 16
- GB Ultimately responsible
- Classification can be delegated – not subject to “undue influence” from IM
- Consistently applied / monitored frequently
- Process enshrined in Valuation Policy Document
- If in doubt consult

Valuation risks

Valuation risks

- Market volatility and changing liquidity
- Extensive use of matrix pricing
- Valuations obtained from a single source or counterparty
- Reliability of data provided by pricing services
- Reliability of information provided by credit rating agencies
- Use of internal information provided by portfolio managers or deal teams to estimate fair values
- Use of internally developed models to value securities
- Process around management overrides
- Timely identification of significant events in performing reliable valuations

Hot topics

Hot topics


Highest and Best Use Principles
Reliability of pricing sources
Broker Quotes Indicative Vs Executed
Documentation lapses
Infrequent valuations
The role of third party valuation experts
Diversification of portfolios
Default to Cost
Fair Value Hierarchy Assessments
Adequacy of Due Diligence

Questions ?

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Panel Discussion

AIFMD & THE ADMINISTRATOR

STUART MARTIN – DECHERT (MODERATOR)

RICHARD FRASE – DECHERT

IAN HEADON – NORTHERN TRUST

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AIFMD & Regulatory Reporting

CHRIS FARKAS

DIRECTOR

DELOITTE

Investor and regulator transparency

Managed accounts

Open Protocol and other Portfolio transparency requests

Increased disclosures in marketing newsletters

Investor risk reporting

Investor tax reporting

FATCA and later CRS

UCITS KIIDs

Systemic risk reporting - Form PF, CPO PQR, AIFMD Annex IV

Fund registrations

Solvency II

EMIR

MiFID

Mini-poll

Regulatory report consuming most time

1. **Systemic risk regulatory reports - AIFMD, Form PF?**
2. **Investor reporting**
3. **Trade reporting**
4. **Investor Tax reporting**

New regulatory initiatives taking most time:

1. **MiFID**
2. **Emir**
3. **Market infrastructure changes - clearing etc.**

Investor and regulatory reporting

Marketing and distribution compliance

AIFMD Annex IV

SEC Form PF

CFTC Form CPO-PQR

AIFMD passport

UCITS passport

NPPR notifications

PRIIPs KIDs

Solvency II

UCITS KIIDs

Marketing Factsheets

Risk reporting

Global and pan-European investor tax reporting

FATCA

CRS

Distribution advisory

Client relationship management systems (CRM)

Tax matrices

Thought leadership

Deloitte.

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Fund Valuation Under AIFMD

A SPECIALIST WORKSHOP FOR AIFM DIRECTORS, OFFICERS, ADMINISTRATORS, ACCOUNTANTS AND LEGAL/COMPLIANCE PROFESSIONALS

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AIFMD & Valuation Policy

IAN BLANCE

MANAGING DIRECTOR

VOLTAIRE ADVISORS

Valuation Policy

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- The creation of appropriate valuation policies and procedures for the assets held in a fund is one of the fundamental building blocks of fund operations
- AIFMD Article 19 and the Delegated Acts require that these policies and procedures be documented and consistent with the national law under which the AIF is domiciled and the rules of the fund itself
- Whilst AIFMD places the onus for valuation on the AIFM, the rules of most AIF domiciles require that the Governing Body both approve these policies and procedures and oversee their implementation and ongoing review
- This oversight role is also recommended by industry bodies (HFSB, AIMA, MFA …) and is considered best practice
- This is not a simple task …

AIFMD Requirements - Documentation

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Article 67 - Policies and procedures for the valuation of the assets of the AIF (1)

- Must exist for each AIF that an AIFM manages
- Must be sound, transparent, comprehensive and appropriately documented
- Must cover all material aspects of the valuation process
- Should include inputs, models and the selection criteria for pricing and market data sources
- Sources should be independent whenever possible and appropriate
- Shall include an assessment of the available relevant methodologies, taking into account their sensitivity to changes in variables

AIFM shall not invest in an asset type unless an appropriate valuation methodology has been identified for that asset

AIFMD Requirements - Roles

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Article 67 - Policies and procedures for the valuation of the assets of the AIF (2)

- Shall set out the obligations, roles and responsibilities of all parties involved in the valuation process
- Shall address at least the following:
  - a) the competence and independence of personnel who are effectively carrying out the valuation
  - b) the specific investment strategies of the AIF and the assets the AIF might invest in
  - c) the controls over the selection of valuation inputs, sources and methodologies
  - d) the escalation channels for resolving differences in values for assets
  - e) the valuation of any adjustments related to the size and liquidity of positions, or to changes in the market conditions
  - f) the appropriate time for closing the books for valuation purposes
  - g) the appropriate frequency for valuing assets

AIFMD Requirements – External vs Internal

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Article 67 - Policies and procedures for the valuation of the assets of the AIF (3 & 4)

- Shall outline a process for the exchange of information between external valuer and AIFM to ensure all data required for valuation is made available
- Shall ensure that the AIFM conducts initial and periodic due diligence on third parties that are appointed to perform valuation services.
- Where internal, shall include a description of the safeguards for the functionally independent performance of the valuation
- Shall include measures to prevent or restrain any person from exercising inappropriate influence over the way in which a person carries out valuation activities.

AIFMD Requirements - Models

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Article 68 Use of models to value assets

- Main features of a model to be explained and justified
- Rationale for choice of model, underlying data and assumptions and the limitations of these to be explained and documented.
- Must be validated by a suitably qualified person not involved in the building of the model – such validation to be documented
- Subject to approval by senior management

AIFMD Requirements - Consistency

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Article 69 Consistent application of valuation policies and procedures

- All valuation methodologies to be applied consistently.
- Designated methodologies shall be applied to all assets within an AIF
- Where no update is required, the policies and procedures shall be applied consistently over time and valuation sources and rules shall remain consistent over time
- Methodologies shall be applied consistently across all AIFs managed by the same AIFM

AIFMD Requirements - Review

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Article 70 Periodic review of valuation policies and procedures

- Shall provide for a periodic review of the policies and procedures – at least annually or where an investment in a new asset class is contemplated
- Shall outline how a change to the valuation policy, including a methodology, may be effected and in what circumstances this would be appropriate.
- Changes subject to approval of senior management
- Risk management function to provide support

AIFMD Requirements – Individual Assets

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Article 71 Review of individual values of assets (1 & 2)

- Shall ensure that all assets held by the AIF are fairly and appropriately valued, document the way that this is assessed and be able to demonstrate at all times that this is the case
- Set out a review process for the individual values, where a material risk of an inappropriate valuation exists, such as in the following cases:
  - a) the valuation is based on prices only available from a single counterparty or broker source
  - b) the valuation is based on illiquid exchange prices
  - c) the valuation is influenced by parties related to the AIFM
  - d) the valuation is influenced by other entities that may have a financial interest in the AIF's performance
  - e) the valuation is based on prices supplied by the counterparty who originated an instrument, in particular where the originator is also financing the AIF's position in the instrument
  - f) the valuation is influenced by one or more individuals within the AIFM

AIFMD Requirements - Reasonableness

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- *Article 71 Review of individual values of assets (3 & 4)*
- Describe the review process on the reasonableness of individual values. Reasonableness assessed in terms of the existence of an appropriate degree of objectivity.
- Such checks and controls shall include at least:
  - a) verifying values by a comparison amongst counterparty-sourced pricings and over time;
  - b) validating values by comparison of realised prices with recent carrying values;
  - c) considering the reputation, consistency and quality of the valuation source;
  - d) a comparison with values generated by a third party;
  - e) an examination and documentation of exemptions;
  - f) highlighting and researching any differences that appear unusual or vary by valuation benchmark established for the type of asset;
  - g) testing for stale prices and implied parameters;
  - h) a comparison with the prices of any related assets or their hedges;
  - i) a review of the inputs used in model-based pricing, in particular of those to which the model's price exhibits significant sensitivity.
- Shall include appropriate escalation measures to address differences or other problems in the valuation of assets.

AIMA Model VPD - Objective

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Objective

- Recommends valuation in accordance with fund Offering Document and sound practice standards to avoid potential for abuse due to vague drafting of fund docs

Responsibilities

- Define various stakeholders involved in valuation and outlines their responsibilities:
  I. Governing Body
  II. Valuation Committee (if applicable)
  III. Investment Manager
  IV. Valuation Service Provider
  V. Other (e.g. Auditor, Independent Accountant, Independent Valuation Expert)
- If affiliate/division of Investment Manager is the Valuation Service Provider, should provide detail on segregation of duties

AIMA Model VPD - Oversight

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Oversight

- Guidelines for the body responsible for oversight of valuation:
  I. Identity (i.e. Governing Body or Valuation Committee)
  II. Quorum
  III. Normal frequency of meetings
  IV. Reports to be presented (e.g. exception reports from Valuation Service Provider)
  V. Outline of approval process for new models/sources
  VI. Frequency of review of the Valuation Policy Document
- If Governing Body delegates oversight function to a Valuation Committee, set out matters that remain reserved for its approval.

AIMA Model VPD - Sources

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Valuation Sources

- Detail price sources for each type of asset, including:
  - I. Type of Asset
  - II. Primary Source
  - III. Secondary Sources
  - IV. Accounting Policy (bid, ask, mid, etc.)
  - V. Cut-off time
  - VI. Tolerable Variance
- Which party would usually be responsible for accessing each price source.
- For more complex instruments, guidance such as:
  - I. Method of deriving an average price from broker quotes.
  - II. Method of acquiring data straight from source and or whether via asset manager.
  - III. Data to be input to pricing models and method of doing so
- Approved Independent Valuation Expert (to be consulted if the usual sources are unavailable)

AIMA Model VPD – Levelling

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Fair Valuation Hierarchy

- Details on how positions should be classified within the fair valuation hierarchy based upon the sources used to price the positions and the observability of market trading on the prices.
- Party responsible for the classifications, process to be followed for authorising movement of positions between hierarchies and format and frequency of reporting to the Governing Body

AIMA Model VPD - Control

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Control procedures

- Will depend on the complexity of instruments traded, but could include:
  I. Procedures for back-testing
  II. Definition of stale prices and procedures for isolating them
  III. Monitoring of trading volume for less liquid instruments
  IV. Process around side-pocketing of investments and when side-pockets are permissible

AIMA Model VPD - Escalation

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Escalation

- 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:
  I. Definition of an Investment Manager override
  II. Definition of materiality
  III. Governing Body (or Valuation Committee) quorum
  IV. Acceptable format and deadline for representations
  V. Timescale for decisions
  VI. Guidance on possible adjudication/arbitration by Independent Valuation Experts
  VII. 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.

10 Key Benchmarks

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1. Ultimate Governing Body Responsibility
2. Documentation & Transparent Disclosure
3. Ongoing Review & Independent Oversight
4. Defensibility & Consistency of Methods
5. Control of Conflicts of Interest
6. Independence & Segregation of Duties
7. Appropriate Expertise & Competence
8. Fair Valuation & ‘Levelling’
9. Prudence & Fairness to Investors
10. Due Diligence of External Providers

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AIFMD & Operational Due Diligence

JEROME LUSSAN

DIRECTOR

LAVEN PARTNERS

Valuation considerations
in an ODD examination

May 2016

LAVEN

LAVEN PARTNERS

Expertise. Vision. Confidence.

Contents

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ABOUT LAVEN PARTNERS

Introduction

Established in 2005 by a forward-thinking finance solicitor and hedge fund COO – Jerome Lussan – Laven Partners is a global consultancy based in London, New York, Geneva and the Caribbeans, servicing the financial industry with a vision to empower banks, brokers and managers by offering robust regulatory solutions that improve their operational processes and structures. Today, Laven Partners remains committed to those same principles and continues to assist clients with their business challenges.

Expertise. Vision. Confidence.

Since 2009, Laven Partners has held the ISO 9001:2008 quality standard designation for the quality and reliability of its independent process of operational due diligence (IPODD)

In June 2012, Laven Partners published the FT Guide to Investing in Funds, authored by Jerome Lussan

Certificate No. FS553272

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WHAT DOES THE LAW SAY?

AIFMD PREAMBLE

- (29) **Reliable and objective asset valuation is crucial for the protection of investor interests.**

AIFMs employ **different methodologies and systems for valuing assets**, depending on the assets and markets in which they predominantly invest. It is appropriate to recognise those differences but, nevertheless, to require in all cases AIFMs to implement valuation procedures resulting in the proper valuation of assets of AIFs.

The process for valuation of assets and calculation of the net asset value should be functionally independent from the portfolio management and the remuneration policy of the AIFM and other measures should ensure that conflicts of interest are prevented and that undue influence on the employees is prevented. Subject to certain conditions, AIFMs should be able to appoint an external valuer to perform the valuation function.

Hedge Fund Review Jan 2008

LAVEN

VALUATION

Asset valuation in hedge funds

By Jérôme de Lavenère Lussan, Laven Partners

The value of some credit-related investments has over the last few months given cause for alarm as to how asset valuation is carried out and again brought this issue to the forefront of investors' concerns.

Valuation is not a new problem and indeed in the hedge fund industry it is notable that most prominent organisations and regulatory bodies such as the UK Financial Services Authority (FSA), the Hedge Fund Working Group (HFWG) and AIMA have all written fairly extensively on the issue and set out standards on how the industry could improve.

The recent concerns have centred on unlisted exotic assets, such as convertible bonds, MBSs, ABSs, CDSs and OTC securities, which are notoriously hard to value and therefore reveal weak industry practices including potential conflicts of interest where valuation is affected by connected parties.

One of the main concerns in relation to valuation is the real risk of poor valuation practices leading to falsely high (or sometimes low) net asset values (NAVs) for some funds.

This creates a significant conflict of interest as the NAV of some funds directly correlates to the manager's high performance fees.

A real conflict of interest risk exists, for example, where the manager of the fund values the assets without any independent guidance or criteria.

It is further notable that even third party administrators have no obligation to seek independent valuation confirmations and often simply refer to either the prime broker of the manager or the manager itself, both clearly conflicted as the higher the NAV, the higher the fees.

VALUATION VOID

The problems with the valuation of illiquid assets stem from the difficulty of not having enough independent sources to value certain products.

It is generally up to the investment manager or a third-party administrator to work out how to carry out such valuations based on certain internal guidelines or "soft" regulations. These regulations need to be strengthened and/or made compulsory in order to have the required impact.

The problem is not related to the fact that there are not enough guidelines, but that most are too lenient or not applied.

Another significant problem on top of adopting a sound valuation approach is determining who holds the ultimate responsibility for valuing these hard-to-value assets.

There are few contracts with administrators who are supposedly independent that impute any responsibility on those administrators. The matter is made worse by the lack of clear guidance in many offering memorandums, which therefore does not guarantee any approach to asset valuation for investors. This common practice is blindly accepted by investors, managers and service providers alike, and leaves one to ponder as to how so many "sophisticated" participants can leave open the void of valuation of the assets under their control or within their ownership.

The recent sub-prime crisis provided further evidence of the valuation issue affecting not only funds but also banks and other financial institutions which somehow were led to invest in poorly valued assets.

Very large institutions worldwide, as well as many hedge funds, have been caught short, by what can only be described as a misconception of risk regarding the original value of an asset. It is probable that this vicious cycle built on itself as many financial institutions learnt to package and sell off risk to other institutions, possibly focusing on the yield of the assets and not their likely value.

Jerome de Lavenère Lussan

According to the Hedge Fund Implode website (*www.hf-implode.com*) over the last 14 years, out of all the implosions of the hedge fund industry, 85% have been due to mis-valued strategies, including fraudulent strategies and sub-prime strategies.

SELF-REGULATION

The HFWG recently published its best practices document in which it suggests ways to improve the uncertainty surrounding valuation practices. The Working Group advocates a valuation methodology that is transparent and robust. This would involve hedge fund managers disclosing the presence of hard-to-value assets in their portfolio as well as informing investors of any conflicts of interests that might arise from the process of valuation.

These suggestions by the HFWG are not new in the industry, at least from a UK perspective. However, so far any efforts to improve the situation internationally have been ineffective in encouraging the industry to make significant changes. The recommendation should be more strictly enforced and rigorously adopted if the industry wishes to avoid future scandals blemishing its image.

> **Finding a solution is important with a view to protecting investors and the reputation of the hedge fund industry.**

REGULATORY BODIES

The FSA in particular sees the conflict of interest problem as one of the main risks that hedge funds face. In Discussion Paper 05/04 the FSA has noted that this could be a potential source for fraud as investment managers might issue false valuations in the absence of methods which could verify their valuations.

More recently, the FSA has given its support to devising international valuation principles for hedge funds which could close the regulatory gap in the industry.

AIMA

AIMA has also recently updated its 2005 global survey on asset pricing and fund valuation practices. Their recommendations support the use of a third-party administrator to eliminate any conflicts of interests and suggest that managers clearly communicate to the administrator how they calculate the value of unlisted assets. This would involve creating a "Pricing Matrix" which describes the methods that managers use.

The report goes further in suggesting that similar securities are valued the same way to avoid cherry-picking quotes and AIMA also underlines the importance of the back office being responsible for valuations to ensure necessary independence.

OUR PROPOSED SOLUTION

Finding a solution is important with a view to protecting investors and the reputation of the hedge fund industry. Unfortunately, unless the valuation references included in offering memorandums are set out in full in line with best practice so that they are transparent and comprehensive enough for managers to abide by and for investors to enforce, much of the guidelines will be ignored until the next scandal.

The same can be said of the administrators' contractual obligations, which most often are void of any liability. The mere fact of independence is clearly not enough to ensure that proper valuation techniques are used, as evidenced by many famous names involved in the recent debacle.

A possible solution to the valuation problem therefore lies in the legal agreements relating to hedge funds as they allocate responsibility for the valuation of assets. Better still would be for investors and prime brokers to insist on the principles being part of the offering memorandum.

Laven Partners wholly supports the idea of improving the adoption of some very good guidelines that currently suggest a methodology and division of responsibility for valuing assets, and more to the point, ensuring that these guidelines are industry-wide in scope and adopted and seen to be implemented. An ideal step forward would be not only to have standardised industry guidance but to actually devise a standard agreement, possibly similar to ISDAs used in the banking industry.

These could be used by managers and service providers across the board as pre-negotiated agreements. This would give investors more confidence in the system and reduce some perverse effects of unequal and biased valuation techniques. It would also have the added value of limiting the political interference that has grown as hedge funds have failed to regulate themselves.

AUTHOR
Jérôme de Lavenère Lussan is director at Laven Partners.

AIFMD PREAMBLE

- (82) **Delegated acts** should also be adopted to specify the requirements that AIFMs have to comply with when investing in such securitisation instruments; to **specify administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms**; to specify the **procedures for the proper valuation of the assets and the calculation of the net asset value per unit or share of the AIF**, the **professional guarantees the external valuer** must be able to provide, and the **frequency for valuation appropriate for open-ended AIFs**.

AIFMD LAW Article 19

- 1. AIFMs shall ensure that, for each AIF that they manage, **appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed in accordance with this Article, the applicable national law and the AIF rules or instruments of incorporation**. 2. The rules applicable to the valuation of assets and the calculation of the net asset value per unit or share of the AIF shall be laid down in the law of **the country where the AIF is established and/or in the AIF rules or instruments of incorporation**. 3. AIFMs shall also ensure that the **net asset value per unit or share of AIFs is calculated and disclosed to the investors** in accordance with this Article, the applicable national law and the AIF rules or instruments of incorporation. The valuation procedures used shall ensure that the assets are valued and the net asset value per unit or share is calculated **at least once a year**. If the AIF is of the open-ended type, such valuations and calculations shall also be carried out at a frequency which is both appropriate to the assets held by the AIF and its issuance and redemption frequency. If the AIF is of the closed-ended type, such valuations and calculations shall also be carried out in case of an increase or decrease of the capital by the relevant AIF. The investors shall be informed of the valuations and calculations as set out in the relevant AIF rules or instruments of incorporation. 4. AIFMs shall ensure that the valuation function is either performed by: (a) **an external valuer, being a legal or natural person independent from the AIF, the AIFM and any other persons with close links to the AIF or the AIFM**; or (b) **the AIFM itself**, **provided that the valuation task is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented**. The depositary appointed for an AIF shall not be appointed as external valuer of that AIF, unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as external valuer and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF. L 174/26 Official Journal of the European Union 1.7.2011 EN 5. Where an external valuer performs the valuation function, the AIFM shall demonstrate that: (a) the external valuer is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct; (b) the external valuer can provide sufficient professional guarantees to be able to perform effectively the relevant valuation function in accordance with paragraphs 1, 2 and 3; and (c) the appointment of the external valuer complies with the requirements of Article 20(1) and (2) and the delegated acts adopted pursuant to Article 20(7).

AIFMD LAW Article 19 (cont) and 23

- 6. The appointed external valuer shall not delegate the valuation function to a third party. 7. AIFMs shall notify the appointment of the external valuer to the competent authorities of their home Member State which may require that another external valuer be appointed instead, where the conditions laid down in paragraph 5 are not met. 8. **The valuation shall be performed impartially and with all due skill, care and diligence.** 9. Where the valuation function is not performed by an independent external valuer, the competent authorities of the home Member State of the AIFM may require the AIFM to have its valuation procedures and/or valuations verified by an external valuer or, where appropriate, by an auditor. 10. **AIFMs are responsible for the proper valuation of AIF assets, the calculation of the net asset value and the publication of that net asset value. The AIFM's liability towards the AIF and its investors shall, therefore, not be affected by the fact that the AIFM has appointed an external valuer.** Notwithstanding the first subparagraph and irrespective of any contractual arrangements providing otherwise, the external valuer shall be liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks. 11. The Commission shall adopt, by means of delegated acts in accordance with Article 56 and subject to the conditions of Articles 57 and 58, measures specifying: (a) the criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per unit or share; (b) the professional guarantees the external valuer must be able to provide to effectively perform the valuation function; (c) the frequency of valuation carried out by open-ended AIFs which is both appropriate to the assets held by the AIF and its issuance and redemption policy.

- Art 23 (g) a description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets in accordance with Article 19;

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INDUSTRY PRACTICES

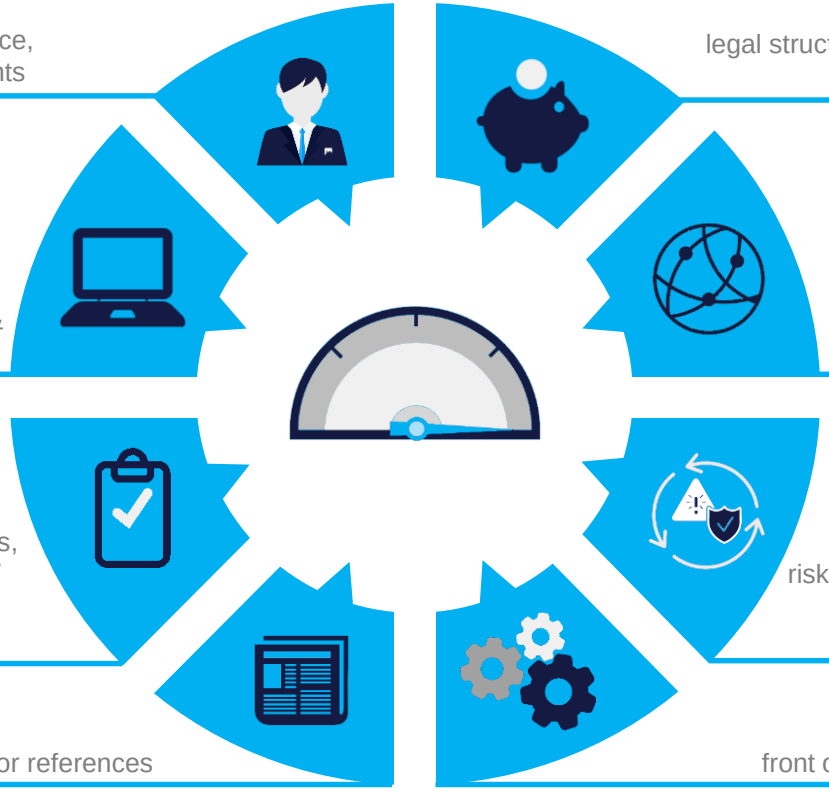
OPERATIONAL DUE DILIGENCE

Management entities
legal structure, corporate governance, investment management agreements

Fund
legal structure, corporate governance, offering memorandum, total expense ratio

Operational infrastructure
key individuals and employees, IT & business continuity, insurance

Service providers
administrator, prime broker/custodian, auditor



Compliance
status, officer, procedures & controls, insider trading, AIFMD/UCITS/SEC/CFTC/MAS/SFC regulations, ESG, FATCA, fund distribution

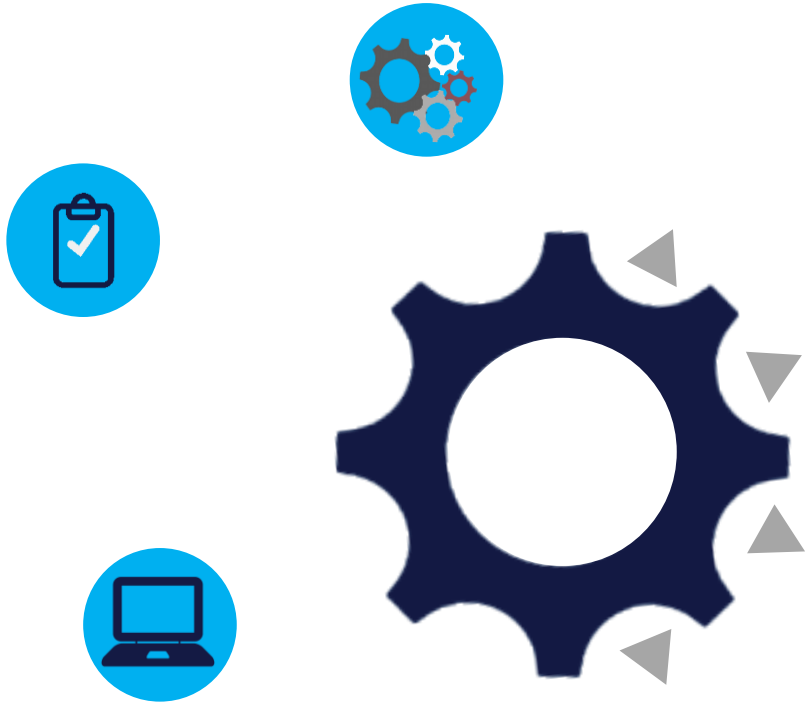
Risk management
risk management function and process, key man risk, valuation risk, counterparty risk

Background checks
key individuals, KYC checks, investor references

Front to back office
front office workflow, back office workflow

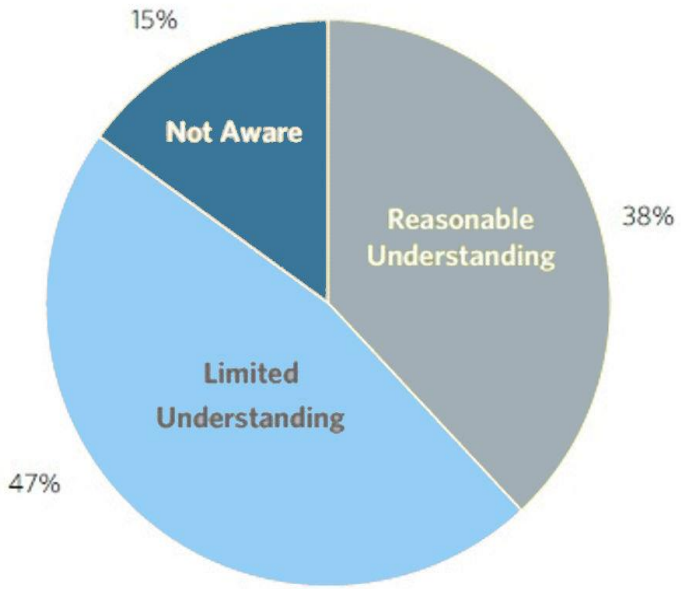
GOVERNANCE & PROCESSES

- Policies/Valuation committees?
- Due diligence on delegation
- **Use of RegTech**
  - Confirming processes



AWARENESS OF AIMA RECOMMENDATIONS

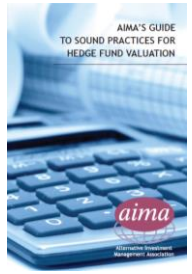
Figure 1: Awareness of AIMA recommendations.
Are you aware of the March 2007 AIMA Recommendations on Valuation?



Source: bny Mellon Hedge fund valutation standards: evolution, not revolution, 2008

BEST PRACTICE STANDARDS

- What AIMA asks?
  - processes for valuations, reconciliations and confirmation of assets
  - investment manager's analysis and monitoring for valuation risk
  - policy with regards to the pricing of illiquid positions
  - external valuation agents
  - valuation committee
  - material discrepancy between an external administrator and the investment manager's own internal estimate on NAV calculation
  - restated NAV
- AIMA valuation Guide 2013



BEST PRACTICE STANDARDS

- What MFA asks?
  - a comprehensive and integrated valuation framework
  - a governance mechanism
  - knowledgeable and qualified internal personnel or qualified third parties to implement the valuation policies and procedures on a day-to-day basis
  - comprehensive, written valuation policies and procedures
    - valuation policies and procedures should adopt an appropriate accounting standard
    - valuation policies should establish appropriate internal documentation procedures to support the valuation for each type of asset
    - valuation policies and procedures should establish procedures for valuing investment positions with no readily ascertainable market value
    - valuation policies and procedures should include, as appropriate, guidelines regarding the use of side pockets and similar arrangements

- MFA Sound Practices for Hedge Fund Managers 2009

MANAGED FUNDS ASSOCIATION

BEST PRACTICE STANDARDS

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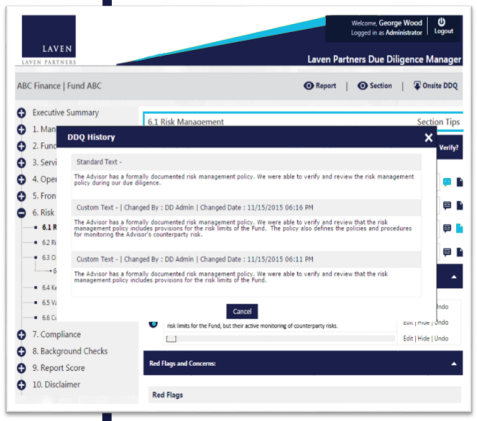
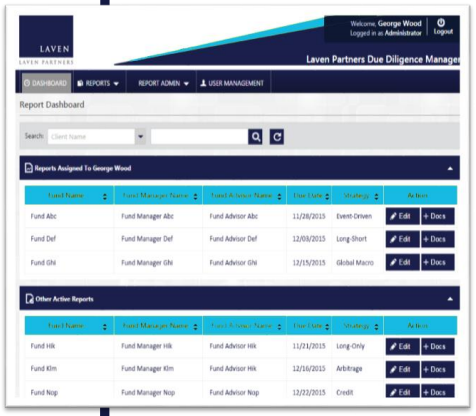
- What standard ODD will ask?
  - The financial statement(s) were audited or unaudited?
  - Financial statement's date
  - Breakdown of Level 1, 2 and 3 assets
  - Does the Fund have a documented valuation policy approved by the governing body?
  - Is there a formal valuation committee for the hard to value assets of the Fund?
  - List of members of the valuation committee?



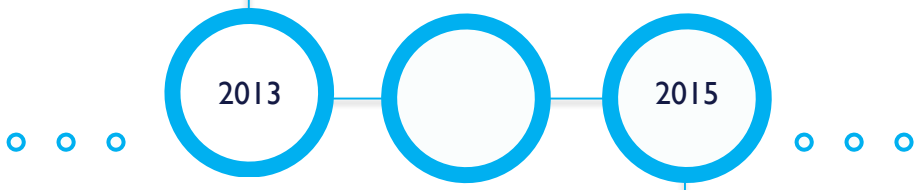


INDUSTRY CASES

- GLG Partners, has been fined $9m after it allegedly told investors that its assets were worth $160m more than they really were
- The company is said to have overvalued the stake it held in a coal mining company by 60pc for 2 years until Nov 2010. As a result, it charged clients higher fees than it was due
- SEC, which levied the fine, said that the error was down to "internal controls failures". "Investors depend upon fund advisers to have proper controls in place to ensure that valuations and fees are not inflated," Antonia Chion, an associate director in the SEC's enforcement division.

Source: http://www.bloomberg.com/news/articles/2013-12-13/glg-to-pay-9-million-to-settle-claims-over-mine-s-value

GLG fined $9m for overvaluing stake



Boaz Weinstein
'Shocked' by Investor Lawsuit

- The former Deutsche Bank star trader and founder of hedge fund Saba Capital was sued by one of his largest former investors for allegedly cheating them as they pulled a once-$500 million investment.
- "First, the suggestion that Saba somehow managed to orchestrate a vast conspiracy to obtain "lowball bids" from numerous broker-dealers for two bonds in our portfolio is ludicrous and totally unsubstantiated.."
- "Second, it is untrue that Saba used this auction process to price the two bonds at the time of PSP's redemption, and then immediately changed our pricing the following month.."
- "The valuation process was transparent, it was appropriate, it was fully vetted by auditors, counsel and others, and it was entirely fair."

Source: http://www.bloomberg.com/news/articles/2013-12-13/glg-to-pay-9-million-to-settle-claims-over-mine-s-value

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Panel Discussion

VALUATION OVERSIGHT & FUND GOVERNANCE

SIMON OSBORN – IFI GLOBAL

(MODERATOR)

AYMERIC LECHARTIER – CARNE GROUP

CHRIS HILDITCH – SCHULTE ROTH & ZABEL

RICHARD PERRY – SIMMONS & SIMMONS

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