Global Fund Valuations - New Regulatory Obligations for NAV & Fund Reporting

Webinar Panel – 5th April 2016

This paper presents a write-up of a panel webinar hosted and moderated by Voltaire Advisors, and commissioned by Thomson Reuters, in April 2016. The session was part of a global program of briefings, with events in Dublin, London, Luxembourg and New York, supporting a Special Report on the subject ***'Global Fund Valuation Standards – Harmony or Discord?'.***

The panel was moderated by Ian Blance, Managing Director of Voltaire Advisors, and included contributions from distinguished industry commentators Olwyn Alexander from PwC, Sam Mulliner from Deloitte, Karl Mackelburg from Thomson Reuters and Chris Johnson from HSBC Securities Services.

Considering questions such as mitigation of conflicts of interest, valuation documentation and disclosure, reviews of policies and procedures and due diligence of external valuation suppliers, the panel provided important insights into many valuation challenges facing funds today.

MODERATOR:

Ian Blance, Voltaire Advisors

Ian Blance is Managing Director of Voltaire Advisors. Ian has over 25 years experience in the financial markets focused on research and valuation of securities and derivatives. He is a regular commentator on valuation and risk issues in the media and a frequent conference speaker.

In his earlier career Ian developed and ran securities valuation operations for two of the five major information vendors and has provided consulting services for the others. Ian spent 4 years as Head of Evaluated Pricing for SIX Financial Information, based in Zürich, Switzerland and 12 years with Interactive Data Corporation, setting up and building their fixed income valuations business in London and subsequently becoming Managing Director of the market leading Evaluated Pricing unit in New York. Before Interactive Data, Ian was an economist and senior bond strategist in investment banking.

PANELISTS:

Olwyn Alexander, PwC

Olwyn is PwC's Global Alternatives Leader and Ireland's Asset & Wealth Management Leader. Olwyn spent several years in New York, focusing on a wide range of alternative investment products, including some of the world's largest global macro investment managers and their specialist hedge fund service providers.

Olwyn currently works with an extensive range of alternative's clients, covering varying strategies, from convertible arbitrage and distressed debt to emerging markets, private equity and real estate. Olwyn has significant consultancy experience, regularly presents at global hedge fund and alternative investment conferences and has published a number of articles on alternative investments.

Olwyn co-chaired AIMA's Guide to Hedge Fund Valuation in 2007 and 2013 and was a member of the expert working group in developing IOSCO's Principles for Hedge Fund Valuation. Olwyn is a board member of the Chartered Financial Analyst Institute in Ireland and has been recently re-elected to AIMA's Global Board as well as serving on the Board of Hedge Fund Cares (Ireland).

Olwyn is a fellow of the Institute of Chartered Accountants in Ireland and obtained her Chartered Financial Analyst charter in 2003.

Sam Mulliner, Deloitte

Sam Mulliner is an Audit Partner in the investment management practice of Deloitte & Touche LLP, overseeing a team of dedicated investment management professionals in the central region marketplace.

Mr. Mulliner has experience serving various investment management companies including registered open and closed-end mutual funds, onshore and offshore hedge funds, fund of funds, master-feeder arrangements, private equity funds, and investment advisers. He has also worked on controls and attest examinations of investment advisers, transfer agents, and principal underwriters of mutual funds. In addition, he has provided GIPS attestation services on performance returns for investment advisers.

Mr. Mulliner has experience in auditing various types of investments including structured fixed income securities and complex derivatives. Within Deloitte, he currently serves as a subject matter resource for alternative investments. He has served various clients in the investment management space including Capital Group, Blackstone, Pacific Life, Waddell & Reed, and American Century Investments.

PANELISTS:

Karl Mackelburg, Thomson Reuters

Karl Mackelburg is the head of Municipal, Sovereign, and Corporate Bond Production for Thomson Reuters Pricing Service, responsible for the daily evaluation of over one million securities. Karl joined Thomson Reuters in 2001. Prior to Thomson Reuters, he worked at Interactive Data for fourteen years holding positions in evaluations and sales. Karl's career began at New York Life Insurance as an analyst in policy owner services. He is a graduate of St. John's University, and holds a Masters in Finance from Fordham University.

Chris Johnson, HSBC Securities Services

Chris joined HSBC Securities Services in 2006 and is the Head of Product Management, Market Data Services. Chris was previously at Threadneedle Investments where he was Head of Investment Information Services. Before then he was a Director at UBS. Chris started work in the city with Laurie, Milbank stockbrokers, in their futures and options operations team, continuing with Chase Manhattan for a further ten years, culminating in three years as head of the equity derivatives middle office. He also headed OTC derivative client valuations at Bankers Trust. Chris is a member of the Chartered Institute for Securities & Investment

Introduction

Our recent Special Report on Global Fund Valuation Standards commissioned by Thomson Reuters looked at efforts to harmonize valuation standards across regional fund jurisdictions. We concluded that, whilst there has been some progress in a number of high level areas, in the operational detail the valuation landscape for investment funds remains a local patchwork.

To review and critique these findings, Voltaire Advisors hosted and moderated a webinar on this topic bringing together senior industry experts to discuss the issues raised in the report. The substance of this panel discussion is reported in this paper.

Panel Session

Ian Blance (IB) – Our report on Global Fund Valuation Standards finds that the identification and mitigation of conflicts of interest in valuation between fund managers, governing bodies and investors is one of the more widely accepted concepts. What does the panel think is the best way to achieve this?

Chris Johnson (CJ) – Top of the agenda here would be segregation of duties. Valuation decision makers need to be completely independent of those who manage the investments. The IOSCO and other regulatory guidelines are consistent on this. The other main requirement lies with governance. Valuation calls, especially with regard to hard-to-price assets, must not be made without proper oversight and transparency.

> ***Top of the agenda here would be segregation of duties. Valuation decision makers need to be completely independent of those who manage investments.***
> Chris Johnson

Olwyn Alexander (OA) – The IOSCO and AIMA guidelines and AIFMD deal explicitly with this, recommending the use of an independent price source whenever possible. However, this is not always feasible for highly esoteric assets, of which there are many in alternative investment strategies. In such a case, ignoring the opinion of the fund manager completely might leave good data and market intelligence on the table. In these circumstances it is important to listen to the fund manager, but ensure that they do not have the final decision. It should be up to a fund's board or pricing committee to assess the evidence and make the final call.

Sam Mulliner (SM) – An important consideration here is the make-up of the pricing committee. Does it have proper checks and balances? Who has a vote and who gets the final call? Sub-advisers also present an interesting issue in the US. Their role is usually one of response assistance or exception assistance, but our recent survey indicates that 13% of respondents have them in an integral role in valuation. This needs proper oversight and approval. There is also a trend (63% in our survey) to have a dedicated senior level person to oversee valuation.

Karl Mackelburg (KM) – We shouldn't forget the daily valuation team. They typically own the vendor relationship, process daily price challenges and exceptions, look at day-to-day market moves, etc. They sit between the front office and the pricing vendor, so they offer a good check on the fund manager.

IB - Who does the daily valuation team report to?

KM – Typically operations.

IB – Our Report also looked at documentation and disclosure of valuation policies and procedures as a key standard. What does the panel think should be documented and to whom should it be disclosed?

OA – AIMA has a skeleton Valuation Policy Document that provides a good framework for this. The document needs to clarify the roles of every party involved in the valuation process, identify price sources (to avoid selective cherry picking), provide guidance on accounting 'Levelling' and side-pocketing, and outline escalation and resolution procedures for exceptions. It is important, though, to make sure that this is reviewed very frequently in light of market and industry changes.

> ***Our recent AIFMD Survey revealed that 15% didn't have a detailed Valuation Policy Document in operation. This is slightly alarming!*** Ian Blance

SM – There also needs to be a link between the risk assessment of the fund and its valuation policy and procedures. To quote the SEC Office of Compliance, Inspections and Examinations (OCIE) their aim is not to second guess you, rather they check that you are following the policies and procedures you report to your investors. The US approach is to make sure that these are appropriate and that they can actually be followed. It is better off not having a policy at all than having one which is not followed!

CJ – We should differentiate between policy and procedure I think. A policy document should be 5-10 pages maximum, providing guidance on key issues which can be used to govern valuation. Operational procedures can be in much more detail.

IB – Certainly, it would be expected that every fund would have a Valuation Policy Document in place today, but our recent AIFMD Survey revealed that 15% didn't have a detailed document in operation. This is slightly alarming! The debate on what should be reported, when and to whom likely lies more in the level of detail rather than the existence of some kind of document.

IB – Olwyn mentioned that the Valuation Policy Document should be reviewed frequently in line with changing market conditions, and our research indicates that a periodic review of the valuation approach is also a generally accepted principle. How often does the panel think valuation policies and procedures should this be reviewed as a matter of course and under what exceptional circumstances should it also come under scrutiny?

SM – It depends! Our US mutual fund survey reports that 72% of funds approve or re-approve their valuation policies annually. This seems to be standard practice. They would tend to revisit these in the event of dealing in a new security type or existing vendor or pricing source issues.

KM – More often than annually would be too frequent for issues such as changing pricing methodology. The circumstances which would require bringing this forward would be the following: emergence of new pricing vendors or consolidation amongst the existing, an unusual spike in price challenges, notable changes in the buying and/or selling of fund shares (indicative, perhaps, or market timing).

CJ – Invested assets can change regularly and so can market dynamics, for instance bond market liquidity, so these factors need to be constantly monitored. As client servicer, however, we don't know what the fund's investment strategy is, so it is difficult for us to take this role. It needs to be driven by the asset owner.

> ***There are many factors that might prompt a review of valuation. Market volatility, illiquid markets, unanticipated events like Lehman, a run on a fund...***
> Olwyn Alexander

OA – There are many factors that might prompt a review of valuation. Market volatility, illiquid markets, unanticipated events like Lehman, a run on a fund. It also depends on frequency of trading in fund shares. Those with daily redemptions need to be much more alert to changing conditions.

IB – One of the most common methods of pricing fund assets is to use an external pricing service. Most standards require such outsourced services to be subject to ongoing due diligence. How often does the panel think such due diligence should take place, and what kinds of questions should be addressed?

KM – From the perspective of one of these pricing services, once a year plus periodic updates when required seems right. We think that the best practice is to bring the actual user of the valuations. They typically ask the most effective questions. An onsite due diligence visit is also useful, to meet the evaluators for the different asset classes. We would also recommend doing a deep dive in a few actual assets – it can be revealing. Users should also look for a SOC 1 report.

> ***We think that the best practice is to bring the actual user of the valuations. They typically ask the most effective questions.*** Karl Mackelburg

OA – PwC has its centralized vendor due diligence in New York. We look at multiple vendors considering such issues as staffing and training, price sources, outliers and how they are dealt with, disaster recovery, IT environment, etc. Karl is right, control reports are a big help.

IB – It is interesting that you mention disaster recovery and the IT environment. There was a recent issue (BNY/Sungard) due to an IT glitch and I know that the SEC are very concerned about service provider dependency at the moment.

SM – As an audit firm, ultimately our concern is whether IT risks would impact the production of financial statements, and this focus might not cover all cyber risks. Relative to the BNY/Sungard issue, this did take some time to sort out due to the fact that the problem occurred with both the operating and back-up system. For the most part our clients see this as an issue specific event with a unique set of circumstances and have moved on.

CJ – The BNY/Sungard problem may well have been a unique event, but it is a fact of life that asset price sources at the vendor level all experience outages at some time. This makes it necessary to have back-up plans in place and not be dependent on a single vendor – we think that 3 sources is the best option wherever feasible.

IB – The concept of external versus internal valuation was enshrined formally in AIFMD. Does the panel think that this was useful? What does the panel think is current practice when it comes to external valuation?

OA – A fund can neatly address conflicts of interest with an external valuer. These tend to work well with Level 1 and 2 assets but become more complicated when it comes to Level 3. We are seeing more use of expert valuers in Level 3 assets to improve independence level, but the esoteric and often private nature of these makes it more complicated. Private equity is much slower to move to external pricing providers for these very reasons.

Continued over page

SM – We are beginning to see US mutual funds investing in private equity, and they are using external and internal valuations for these. The distinction between external and internal valuation is useful to address certain risks, especially conflict of interest as Olwyn mentions, but it needs to borne in mind that there also risks with the use and oversight of external valuers. We see a common practice of running the two approaches in parallel.

> ***We see a common practice of running the two approaches (internal and external valuation) in parallel.*** Sam Mulliner

CJ – AIFMD provides a specific definition of an External Valuer. What it effectively means is that an AIFM needs to buy-in the segregation of valuation duties if it is not big enough to do it internally. This is a different concept to the use of external pricing vendors – it is a governance issue and involves matters like making fair value calls rather than evaluation of asset prices themselves.

KM – As a pricing vendor we are naturally biased towards external evaluations! Internal data is very valuable, but it is not appropriate to rely on this entirely. As Chris mentions, the External Valuer concept in AIFMD is not the same as a pricing vendor – we do not act as an External Valuer, but rather provide pricing inputs into the process.

IB – Thank you all for your valuable insights. Anyone interested in reviewing the Special Report or listening to the actual webinar can do so on our microsite listed below and we welcome any feedback.

FURTHER INFORMATION:
http://voltaireadvisors.com/global-fund-valuation-briefings-micro-site.html

The Thomson Reuters Pricing Service is a leading pricing service for OTC, derivative and illiquid assets.

Every day, thousands of investors around the world use our independent evaluated prices to accurately value their portfolios and power their risk, compliance and investment workflows.

Backed by a team of experts around the globe, our pricing service offers high-quality, transparent valuation and pricing data updated throughout the day. Price recipes, corresponding market color and associated relevant data sets are available at the touch of a button.

ARE YOU USING THE BEST EVALUATED PRICING SERVICE?

To find out why thousands of other buy-side firms rely on Thomson Reuters every day for their portfolio valuations, visit prdcommunity.com.

The intelligence, technology and human expertise you need to find trusted answers.

the answer company™
THOMSON REUTERS®