

Hedge Fund Alert

A periodic update on trends and developments affecting the industry

IOSCO Seeks Comment on Proposed Hedge Fund Portfolio Valuation Principles

The Technical Committee Standing Committee (the “Committee”) on Investment Management of the International Organization of Securities Commissions (“IOSCO”) published a report (the “Report”) proposing a single, global set of principles for the valuation of financial instruments employed or held by hedge funds (the “Principles”). Each Principle is accompanied by specific guidance regarding its implementation through comprehensive hedge fund portfolio valuation policies and procedures. The Report focuses on challenges that arise when valuing illiquid or complex financial instruments and notes that significant leverage employed as part of hedge fund investment strategies increases the importance of establishing appropriate values for a hedge fund’s financial instruments. The Report also discusses the concerns driving the Principles’ development.

The goal of the Principles is to seek to ensure that a hedge fund’s financial instruments are appropriately valued and, in particular, that those values are not distorted to the disadvantage of fund investors. The Report also identifies a related goal of promoting, among other things, the consistent application of a set of valuation policies and procedures for the valuation of hedge fund portfolios, and independence in, and transparency of, the valuation process.

The Principles are designed to be applicable across a wide range of jurisdictions, as well as a number of different hedge fund and service provider structures. The industry/regulator working group that contributed to the Report consisted of 23 representatives from the hedge fund industry, including investment managers, service providers and U.S. and foreign regulators, four of whom were representatives from the SEC. The Report includes an extensive bibliography of sources, many of which are available on the Internet.

The nine Principles are as follows:

1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund.
2. The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund.
3. The financial instruments held or employed by the hedge fund should be consistently valued according to the policies and procedures.

4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.
5. A hedge fund's governing body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed.
6. The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and in particular of any valuation that is influenced by the hedge fund's investment manager.
7. A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an independent party (which may be a separate group within the investment manager's organization).
8. A hedge fund's governing body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.
9. The arrangements in place for the valuation of a hedge fund's investment portfolio should be transparent to investors.

The Principles are intended to be a practical tool that can be used by hedge fund investment managers, the governing bodies of hedge funds and others involved in the hedge fund valuation process. The Report also indicates that the Principles may be of use to institutional investors, sophisticated individual investors and their representatives, and it in fact urges investors to be vigilant with respect to any hedge fund that does not exhibit the Principles throughout all aspects of its valuation process.

IOSCO seeks comment from the public, including investors, investment managers, the governing bodies of hedge funds, hedge fund counterparties and service providers on all aspects of the Report, including certain specific issues identified in the Report itself. Comments may be submitted at the latest on June 21, 2007. IOSCO expects to publish a final paper in the fall of 2007.

The Report is available on IOSCO's website at:
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>

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