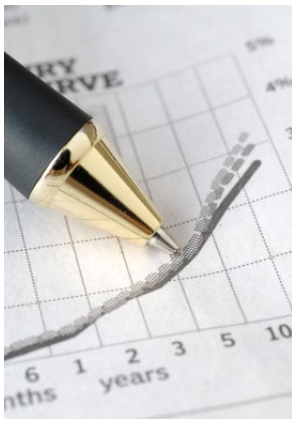
Pluris

HEDGE FUND

PORTFOLIO VALUATION



Reputational and career damage aside, what is the monetary penalty for failing to obtain a third-party valuation on two illiquid private equity investments? The answer is $1 million. Brantley Capital Management recently paid this amount to settle SEC charges that the firm overvalued investments in order to charge higher investment advisory fees. Specifically, the complaint accused Brantley of making material misrepresentations and failing to make required disclosures for two investments to the board, auditors and investors.

The problem of hedge funds failing to properly value illiquid assets is so big that the SEC recently established an asset management team in its enforcement division to focus solely on hedge funds, including hedge fund valuation methods and policies.

Several fund managers have disclosed to investors that they are being questioned, including Vision Capital, RAM Capital and NIR. What they all have in common is that independent valuations would have cost a fraction of the potential losses they now face from portfolio mis-valuation.

This paper explores the hurdles of valuing illiquid securities in today's economic environment, and how hedge fund managers can overcome them. In our experience, there are four key elements to an effective defense in the event of a valuation challenge:

1. Transparent, thorough internal valuation processes
2. Audits by a reputable auditor
3. Documentation of the valuation analyses and methods applied
4. Independent, outside validation of value estimates

This paper will walk through each of the elements and will conclude with a discussion on side pocketing practices.

BACKGROUND

Brantley is not alone. This past April, the SEC charged Morgan Keegan (Morgan) with fraudulently overstating the value of securities backed by subprime mortgages. The SEC's Division of Enforcement alleged that Morgan failed to accurately calculate net asset values (NAVs) for five funds, then sold shares to investors based on inflated prices.

The SEC alleged that Morgan made "price adjustments" that increased the fair values of certain portfolio securities. The price adjustments ignored lower values for the same securities quoted by various dealers as part of the pricing validation process. With many of the funds' securities backed by subprime mortgages, Morgan's actions allegedly prevented a reduction in the NAVs of the funds that should have occurred as a result of deterioration in the subprime securities market.

The SEC also alleged that Morgan did nothing to remedy deficiencies in the firm's valuation procedures as required to ensure that fair-valued securities were being accurately priced and NAVs were being accurately calculated.

According to the SEC, each fund held various amounts of securities backed by subprime mortgages and lacked readily available market quotations. The securities were internally priced based on what the funds would expect to receive from a current sale of each security. In SEC filings, the funds stated the fair value of securities would be determined by a valuation

...Improper valuation techniques can affect portfolio balancing, asset allocation strategies and performance reporting.

committee using procedures adopted by the funds. In fact, the responsibility was essentially delegated to Morgan, which, along with the valuation committee, failed to comply with the funds' procedures in multiple ways.

In many cases, prices for securities held by mutual funds are readily determinable. However, if securities are traded in markets that are not considered active, prices for a fund's holdings may be more difficult to obtain. Securities such as distressed debt and restricted securities, for example, trade in markets that are not considered active, so pricing is not readily available. Significant analysis may be required. This process is typically handled by a fund manager's fund accounting group, which follows procedures established by the fund's Board of Directors and Valuation Committee.

The operational facets of hedge fund valuations are numerous and the need to refine valuation policies is growing. Improper valuation techniques can affect portfolio balancing, asset allocation strategies and performance reporting. These, in turn, affect subscriptions, redemptions and liquidation, and ultimately compliance, risk management, potential litigation, and the accuracy and timeliness of financial reporting. All of this, in one form or another, affects the fees paid to asset managers and the returns reported to investors.

The SEC also restricts how much certain funds can invest in illiquid securities. Yet, in the early '90s, the SEC increased the percentage of illiquid securities that open-end management investment companies could hold from 10% to 15%. Since that time, mutual funds have moved into some less liquid areas, such as private equity, venture capital investments and PIPEs (private investments in public equity). Improper valuations can throw a fund close to the 15% line and out of compliance.

Practically speaking, valuations that are too high means the subscription price will be too high, while valuations that are too low adversely affect investors seeking to redeem funds. Managers have a natural bias toward overvaluation, because valuations are used to determine performance and management fees. In addition, valuation procedures should be documented and how exceptions are handled should be discussed. Policies must meet tight internal control standards, with attention paid to maintenance and documentation.

THE INTERNAL VALUATION PROCESS

General partners and Boards of Directors of funds bear a fiduciary responsibility to provide accurate and timely valuations. In addition, trustees must perform due diligence before making decisions about investments in hedge funds. This is a comprehensive effort where issues of transparency, liquidity, methodology and fund performance are raised, vetted and resolved. For example, with respect to a fund's use of derivatives, regulatory guidance is clear and well-established (US DOL PWBA Office letter, March 21, 1996):

> *If the plan is investing in a pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances.*

> *In determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan's investment policy, what role the particular derivative plays in the plan's portfolio, and the plan's potential exposure to losses. While derivatives may be a useful tool for managing a variety of risks and for broadening investment alternatives in a plan's portfolio, investments in certain derivatives, such as structured notes and collateralized mortgage obligations, may require a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments. Characteristics of such derivatives may include extreme price volatility, a high degree of leverage, limited testing by markets, and difficulty in determining the market value of the derivative due to illiquid market conditions.*

A hedge fund's pricing and valuation policies should be formalized in the fund's offering documents. Fund managers need to pay particular attention to establishing policies related to illiquid securities. The valuation method should be consistently applied from period to period and from fund to fund. The following guidelines can be followed:

- In properly segregating duties, checks and balances should ensure that asset managers do not have independent sign off on performance reports used for compensation for themselves or others.
- A separate valuation committee is a critical element – and should include managers that are not primary recipients of "2 and 20".
- In establishing policy, review best practices of other funds regarding how net asset value will be determined and what disclosures will be made in the offering documents.
- Document specific cases where significant judgment was used in valuing illiquid securities, including the underlying support for such judgment.
- Executive management should sign off on all significant valuations of illiquid securities holdings.
- When changes or enhancements to valuation policies are necessary, determine whether they represent errors or changes in accounting estimates. Sometimes there is a fine line between the two.
- After being performed by an independent firm, valuations should be appropriately reviewed by management and the audit team.

With the increasing popularity of data feeds and enterprise-wide pricing applications, hedge funds have the necessary tools to make the pricing process better than ever.

In some cases, hedge fund managers may choose to develop internal pricing models. This can be an uphill challenge to defend, as many audit teams prefer an independent, third-party valuation. However, fund managers may take the position that no one knows the securities' value better than them due to their daily market activities, securities industry experience, and pricing expertise. In these cases, managers must be able to explain and support model assumptions and parameters. Internal valuation models should be independently reviewed and verified. Alternatively, managers may obtain pricing information from an independent pricing service that provides a market value or assists the fund in estimating fair value. For example, prime brokers and administrators often offer valuation services.

...“Proving” a specific value may not be easy, but demonstrating good faith ought to be.

Many variables must be considered when valuing illiquid positions, including type, form and frequency of data, although determinants of fair market value depend on what is being valued. For example, the estimated fair market value of a portfolio of mortgage-backed bonds relies heavily on interest rate variables, such as yield curve shape, past interest rates and the effect on pre-payment. In contrast, the determinants of fair market value of a majority ownership stake in a closely-held company include, but are not limited to, the organizational form of the company, the industry, the quality of management, number and maturity of patents and trademarks, market share, access to capital, dividend distribution patterns, the number of owners and degree of control of each owner, and so on. Data is not always readily available and may differ in quality by type of variable. Even when data can be purchased, it is not always presented in the same way by each vendor. It is critical to understand how the data is prepared so that the resulting opinion of value can be interpreted correctly.

A manual of written policies and procedures with details for valuing each asset class held by a fund is critical. Policies and procedures should be applied consistently from period to period and between similar asset classes. In addition, appropriate disclosures about any limitations should be included.

Valuation policies should identify those involved in the valuation process and establish valuation methodologies appropriate for each class of investment. Procedures should be developed to ensure that the policies are practical and that staff members are complying with them. The policies should adequately define the roles and responsibilities of all parties involved in the valuation processes, including management, auditors and the valuation firm. A discussion of valuation methodology should include guidelines for how illiquid securities will be priced, including sources of data. Policies should also address internal documentation procedures and the steps in place to deal with any significant departures from policy.

THE AUDIT

It is critical to retain an auditor who specializes in investment firms and has significant in-firm depth of expertise specifically with hedge funds. For most clients, this means either a big 4 auditor or a regional or national firm that specializes in hedge funds. The best reason to select a top quality firm is that the firm tends to work harder to preserve its reputation. The best way to identify a qualified accounting firm is by word of mouth. A quality firm will require corroboration of material fair value estimates and test the related valuation methods. Integrity is another critical factor, which may require significant due diligence before retention, especially if the proposed auditor is a lesser known firm. The auditors, however, are prohibited from developing their own valuation estimates as they cannot properly audit their own work.

THE DOCUMENTATION

Having a robust internal valuation process, with checks and balances, will not help much in the event of a valuation challenge unless the process is documented. Significant benefit of doubt is owed managers in a valuation challenge. Valuation is an inherently subjective effort. It involves estimates and expectations of future performance, and the fair value rules themselves are not always clear enough or well-established enough that they have acquired an undisputed meaning.

Given the significant leeway managers have, if the valuation file is complete, with prints of transactions in comparable securities backing each valuation estimate, this will go a long

"...internal valuations can be generated in parallel with outside independent valuations, and both (or more) estimates vetted through the valuation committee."

way. An outside regulator might still disagree with the valuations, but anything in the "gray zone" should be immune to charges of fraud. "Proving" a specific value may not be easy, but demonstrating good faith ought to be.

THE INDEPENDENT VALIDATION

The final element of a good defense in a valuation challenge is independent review and validation. The absolutely best process is for an independent valuation firm to value the entire portfolio of illiquid securities and for those values to then become the starting point for the internal valuation process of fund management and the valuation committee. Alternatively, internal valuations can be generated in parallel with outside independent valuations, and both (or more) estimates vetted through the valuation committee. When the resulting NAV estimate goes through the audit process, the end result will have a validity and robustness that isn't achievable without independent valuations.

In addition to providing its own valuations, valuation firms can offer a review of management's valuations of fund investments. This, which essentially results in a positive or negative "assurance letter," is a lower-cost option but still substantially better than a purely internal process.

SIDE POCKETING

Side pockets are currently used mostly to distinguish between illiquid and liquid assets. Typically, the size of a side pocket is capped at 15% to 30% of total assets. After an investment gets "side pocketed," only current investors may receive a share of the proceeds when gains and losses are realized. Investors who sell their holdings still receive a share of the side pocket's value. Usually, only the most illiquid assets get side pocketed, because holding illiquid assets complicates liquidation.

The use of side pocketing avoids having to value an illiquid security each time there is a withdrawal from the fund. It also protects investors against poor timing of withdrawals and may decrease the risk of illiquidity issues for limited partners. Because side pockets raise questions of liquidity mismatch, lawyers caution against their use and advise that there are other ways to hold onto long-term assets, such as through the use of lock-ins, that prevent investors from exercising early redemption.

However, while side pockets may present an attractive accounting solution for the valuation of illiquid securities, one disadvantage is that components of portfolios are ignored. For example, from a risk management standpoint, diversification metrics may not accurately represent the characteristics of the portfolio. Side pockets may also raise disclosure questions, as their use must be reflected in the fund's setup and marketing documentation. They also present difficulties for managers when it comes to determining fees.

Given these issues, the decision about what qualifies an illiquid investment for a side pocket should be carefully evaluated. Side pockets must be structured to match investor interests with those of managers. For example, the criteria used by a manager to move an investment to a side pocket must harmonize with what's important to investors. Because the manager earns his fees based on fund performance over a high threshold, there is an inherent conflict of interest. For example, the manager may tend to side pocket under-performing assets to maximize performance fees. Policies for moving investments to side pockets should be

reviewed by fund directors or an investment advisory committee. Governing documents should disclose limits on levels of investments that may be allocated.

Finally, policies should include implementation guidance for the treatment of illiquid securities and "side pocket" investments. Because of the inherent conflicts of interest and biases when using internal valuation models, use of an independent third-party valuation firm is highly recommended not only to mitigate conflicts and ensure the accuracy of valuations, but to provide a defensible position if the firm's valuations are under scrutiny.

In summary, controversial issues include the extent of manager discretion to designate investments into a side pocket, the criteria for designation, whether valuation is performed by the manager or by an independent firm, the effect of valuations of the side pocket on incentive fees, and whether regular management fees should continue to be paid on the side pocket or should be accrued until value of the side pocket is realized.

CONCLUSION

Illiquid securities present unique valuation methodology and policy challenges to hedge fund managers and stakeholders. Complex SEC rules, ever-changing accounting rules and practices such as side-pocketing demand greater involvement of independent third-party valuation firms. The ultimate goal is a well-documented process where internal and external forces are applied to the valuation challenge, where the estimates are insulated from bias, and where the end result is as defensible as it can possibly be.

New York Office
26 Broadway
Suite 1202
New York, NY 10004
212.248.4500

California Office
335 Bryant Street
2nd Floor
Palo Alto CA 94301
650.485.4049

www.pluris.com

ESPEN ROBAK, CFA, PRESIDENT

Espen Robak is President and founder of Pluris Valuation Advisors LLC and a nationally recognized expert on intellectual property and business valuation, restricted and illiquid securities, securities design, levels of value, and discounts for lack of liquidity. Pluris' practice includes portfolio valuations for investment funds and financial institutions, as well as a broad range of financial reporting and tax opinions for public and private companies. Mr. Robak is a frequent contributor to books and professional journals on valuation, accounting and taxation topics. He is a columnist for Wealth Strategies Journal.

RICK MARTIN, CPA, VICE PRESIDENT

Rick Martin, Vice President of Technical Accounting, is in charge of resolution of technical accounting issues as they pertain to our valuation clients, and manages our relationships with the accounting and audit professions. Prior to joining Pluris, Mr. Martin served as Head of Technical Accounting at Cowen and Company in New York and Senior Technical Accounting Advisor at Credit Suisse in Zurich, as well as technical accounting roles at all the big 4 accounting firms.

PLURIS VALUATION ADVISORS

Pluris Valuation Advisors has 15 employees across offices in New York and California and specializes in business valuations and hard-to-value, illiquid, and distressed securities. Pluris is especially well-known for its empirical research and proprietary databases on valuation discounts. Our research and analyses have been covered by the Wall Street Journal, Financial Times, New York Times, Forbes, American Banker, CFO Magazine, CPA Journal, Compliance Week, Absolute Return, Opalesque, Hedge Fund Law Report, Journal of Alternative Investments, and Hedge Fund Manager Week, among others.

Pluris clients include large institutions, investment funds, public and private companies and their shareholders and executives, as well as high-net-worth individuals and families that require estate tax, gift tax or income tax valuations. Finally, Pluris provides valuation testimony and has provided valuation services in a number of cases. Our institutional clients include firms such as Goldman Sachs, Morgan Stanley, Credit Suisse, and Jefferies and our corporate clientele include more than 100 public companies. On the tax-planning side, Pluris personnel have worked for some of the largest estates and some of the richest families world-wide.