CFA INSTITUTE | Centre for Financial Market Integrity

21 June 2007

Ms. Pamela Vulpes
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

Re: Principles for the Valuation of Hedge Fund Portfolios

Dear Ms. Vulpes,

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre")[1], in consultation with the 11 volunteer professionals on its Capital Markets Policy Council (the "CMPC"), is pleased to comment on the consultation of the International Organization of Securities Commissions ("IOSCO"), *Principles for the Valuation of Hedge Fund Portfolios* (the "Consultation"). The CFA Institute Centre represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the efficiency and integrity of global financial markets.

Summary and Interpretation of Consultation

IOSCO proposes nine principles relating to hedge fund valuations. The Principles are:

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 hedge funds 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.

[1] The CFA Institute Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, Virginia, USA, and regional offices in London, Hong Kong, and New York, CFA Institute, is a global, non-profit professional association of nearly 91,500 financial analysts, portfolio managers, and other investment professionals in 134 countries and territories of which more than 78,200 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 134 Member Societies and Chapters in 55 countries and territories.

Charlottesville New York Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

5. The 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 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.

8. The 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 the hedge fund's investment portfolio should be transparent to investors.

As referenced in the Consultation, IOSCO is aware of the CFA Institute Centre's *Asset Manager Code of Professional Conduct* (the "AMC"). The AMC outlines the ethical and professional responsibilities that fund managers owe to their clients and sets standards for asset management firms and their conduct. It considers firms' relationships with clients, the investment process, trading, compliance and support, performance and valuation, and disclosure. The portions of the AMC dealing with the valuation of hedge fund portfolios are included in Section E ("Performance and Valuation"), Section F ("Disclosures"), Section B ("Investment Process and Actions"), and Section D ("Compliance and Support").

The Principles do not conflict with the standards set in the AMC. To the contrary, the Principles supplement the suggested conduct relating to valuation in the AMC with more detail specifically relating to the valuation of fund portfolios.

Consequently, the CFA Institute Centre supports the Principles as drafted by IOSCO and their implementation by hedge funds. However, in the comments below, the CFA Institute Centre makes suggestions on how IOSCO should modify the Principles to ensure goal of providing consistent, understandable, and transparent valuations is achieved.

General Comments about the Consultation

Unlike traditional investment funds, hedge funds make use of a wide variety of investment instruments. On the one hand, they invest in liquid, publicly traded equity or fixed-income securities or exchange-traded derivatives ("Quoted Securities") whose price quotes are readily available from a number of public sources. Increasingly, though, hedge funds also make use of complex, illiquid, and often one-of-a-kind financial instruments such as over-the-counter derivatives, contracts for difference, private equity interests, venture capital, and thinly traded exchange traded derivatives, equity securities, and bonds, not to mention bank loans and other sources of leverage (collectively, "Negotiated Instruments"). It is these Negotiated Instruments which pose the greatest appraisal risk for investors, counterparties, and regulators, alike, and create the most difficulty for those individuals and firms involved in the valuation of such instruments (the "Appraisers").

The valuation procedures proposed in the Principles are needed, IOSCO notes, because of the sector's significant role in providing liquidity and innovation to global capital markets. Such valuations are also important, however, for determining the compensation of fund managers and, even more importantly, the solvency of the funds and their influence on the financial condition of counterparties.

The CFA Institute Centre believes that any valuation of Negotiated Instruments should include the disclosure of four elemental valuation considerations (the "Four Elements"): 1) the models used; 2) the assumptions employed; 3) the investment instruments being appraised; and 4) the structure underlying the appraised investment instrument. Investors and counterparties need disclosures about these elements to independently assess portfolio values, financial condition, and risks accepted by dealing with these funds.

The Principles call for disclosure of some of these considerations. For example, Principle 2 calls on funds to disclose the models and inputs used. However, it is imperative that funds also disclose and discuss the nature of the instrument and of the underlying structure if investors and counterparties are to understand the risks involved and assess the viability of the assigned valuations.

The CFA Institute Centre also is concerned that the Principles may be interpreted as a one-sided approach to valuation of financial instruments used by hedge funds. Specifically, the implication carried throughout the Consultation is that it is concerned with the valuation of financial instruments that are held as assets on the balance sheets of the funds; there is no mention of the valuation of instruments that create liabilities for the funds. To this end, the CFA Institute Centre suggests that IOSCO modify the Principles to calls on funds' governing bodies to direct third-party or in-house Appraisers to consider the valuation of debt instruments employed by the fund in order to provide a more accurate picture of a fund's financial condition.

Finally, while recognizing IOSCO's wish not to create a document that dictates how valuations are created, the CFA Institute Centre believes that IOSCO should include in its guidance a hierarchy of valuation methods. In particular, Appraisers should look to public quotations as the best proxy of value for Quoted Securities. When quotations are not readily available, they should call for the use of widely accepted valuation techniques and methods. And only in those cases where traditional valuation techniques and methods are not applicable should Appraisers use proprietary valuation models. In both of the latter two situations the Principles should call on funds to disclose the Four Elements discussed above.

In the paragraphs that follow, the CFA Institute Centre provides responses to the specific questions raised by IOSCO in the Consultation.

Specific Questions

Question 1: What is your opinion of each of the Principles?

In general, the CFA Institute Centre supports the use of the policies and disclosures contained in the Principles. It is anticipated that the Principles will promote investor understanding about the valuation of illiquid financial instruments.

However, it is reasonable to interpret Principle 2 and its related guidance as not seeing one valuation methodology as superior to any other. In particular, the supporting guidance to the Principle calls for funds merely to disclose, among other things, "the selection criteria for pricing and market data sources." It continues by stating that the "selection process for a particular methodology should include an assessment of the different relevant methodologies that are available by appropriately qualified and experienced parties."

As stated above, the CFA Institute Centre believes IOSCO should at least suggest in the guidance to the Principles a hierarchy of valuation methods beginning with readily available market quotations for Quoted Securities. When dealing with Negotiated Securities where quotations are not readily available, the Principles should call upon Appraisers to use widely accepted valuation techniques and methods. Finally, in those cases where it is not possible to use traditional valuation techniques and methods, the Principles should call for full disclosure of how the valuation model works and any assumptions included, and describe both the instrument valued and the structure underlying the instrument. Only with this information will investors and counterparties be able to determine the appropriateness of the valuations and the appropriateness of transacting with the fund.

Question 2: Has IOSCO correctly identified the challenges inherent in the valuation of hedge fund financial instruments?

The CFA Institute Centre believes the challenges IOSCO has identified are relevant and inherent in valuation of hedge fund portfolios. As noted in its suggestions above, the CFA Institute Centre believes the challenges also include consideration of the value of the fund's liabilities and an understanding of the structures underlying the investment instruments used.

Question 3: Has IOSCO correctly addressed those challenges?

One specific challenge that IOSCO identifies in the "drivers" of IOSCO's focus on hedge fund portfolio valuation but doesn't address in the Principles is the issue of conflicts of interest. While Principles 5 and 6 deal with one aspect of this issue by requiring "independence" in applying the recommended policies and procedures and in the review of the values generated, there is little to direct hedge funds, their managers, and their governing bodies on the need to manage such conflicts.

The CFA Institute Centre believes hedge funds should identify and consider the real and potential conflicts of interest in their businesses and manage them on an on-going basis. In part this requires fund managers to have policies and procedures to ensure adherence to their legal, regulatory, and ethical obligations, the valuation of their portfolios, and management of any conflicts of interest, among other things. It also requires funds to appoint compliance officers to administer those policies and procedures. Finally, it requires managers to disclose its conflicts of interest, including those inherent in their valuation procedures or with any of the Appraisers they may hire. Such disclosures should be made prominently, clearly, and in close proximity to disclosures relating to valuations provided by third parties.

An additional challenge not specifically addressed is the valuation of any instruments creating leverage for the fund. These instruments include, among other thing, margin accounts, borrowed share accounts, outstanding debt and credit facilities, and any other instruments of leverage. The CFA Institute Centre suggests that IOSCO include in its guidance to Principle 1 a call for application of valuation policies and procedures to instruments creating leverage.

Question 4: In what way could the Principles be amended to further benefit investors in hedge funds?

Please see the suggestions provided above in response to Questions 1 and 3 above.

Question 5: Are there material obstacles to the implementation of the Principles within hedge funds?

In general, application of these Principles will depend on the interest and ethical bearings of the hedge fund, hedge fund manager, and, to a lesser extent, the fund's governing body. Moreover, even if a fund manager were to advertise its adoption of the Principles, enforcement will remain difficult.

To overcome this concern, IOSCO and its members could permit hedge funds to cite adherence to the Principles as a means of indicating an ethical and verifiable approach to portfolio valuation. To receipt such sanction, funds would have to make their valuations verifiable to either local regulatory authorities or respected and independent third parties. In such situations, receipt of such an imprimatur could enhance the marketability of the fund and the manager to other investors. The loss of such recognition, on the other hand, could lead to the fund not having access to certain investment funds of entities such as pension funds, and thus potentially create a need for compliance with the Principles.

Question 6: Are there additional Principles that would benefit hedge fund investors?

Please see the suggestions provided above in response to Questions 1 and 3 above, and under "General Comments Regarding the Consultation."

Question 7: What, if any, additional specific measures should be incorporated within the policies and procedures to enhance the Principles?

CFA INSTITUTE | Centre for Financial Market Integrity

As noted in the response to Question 5, the CFA Institute Centre suggests that IOSCO and its members permit hedge funds to cite adherence to the Principles where verifiable. The goal is to enhance the marketability of funds and managers complying to the Principles.

Concluding Comments

The CFA Institute Centre appreciates the opportunity to comment to IOSCO on its consultation, *Principles for the Valuation of Hedge Fund Portfolios.* If you or your staff have questions or seek clarification of our views, please feel free to contact James C. Allen, CFA, at +1.434.951.5558 or james.allen@cfainstitute.org.

Sincerely,

/s/ Kurt Schacht
Kurt Schacht, CFA
Managing Director
CFA Institute Centre
for Financial Market Integrity

/s/ James C. Allen
James C. Allen, CFA
Senior Policy Analyst
CFA Institute Centre
for Financial Market Integrity

Ms. Pamela Vulpes
IOSCO General Secretariat
Re: Principles for the Valuation of Hedge Fund Portfolios
21 June 2007

CFA Institute Centre for Financial Market Integrity
Capital Markets Policy Council
Volunteer List

Frederic P. Lebel, CFA - Chair
Senior Vice President
Lombard Odier Darier Hentsch & Cie
Geneva, Switzerland

Nancy H. Bertand, CFA
Citgroup
Toronto, ON, Canada

Peter Brennan, CFA
MidCap Investors, LLC
New York, NY, USA

Daniel P. Broby
B.I. Asset Management A/S
Kobenhavn, Denmark

Denise M. Farkas, CFA
Chief Investment Officer
Sigma Investment Counselors
Cleveland, OH, USA

Stephan Illsinger, CFA
Head of Asset Allocation
Swiss Life Germany
Munich, Germany

Aaron H.W. Low, Ph.D., CFA
Lumen Advisors, LLC
Singapore

Tim McCafferty, CFA
McCarthy Tetrault, LLP
Vancouver, B. C., Canada

Raymond F. Orr, CFA
Balgowlah Heights, Australia

Yasuhiro Oshima, CFA
Managing Director
Head of Financial Institutions Group
Societe Generale
Tokyo, Japan

Ann Yerger, CFA
Executive Director
Council of Institutional Investors
Washington, DC, USA