

Citi's Hedge Fund Services – Ernst & Young Q&A

Excerpts from Hedge Fund Event



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Citi hosted a Q&A for hedge fund clients on a variety of issues facing the industry. Featured during the discussion were keynote speakers from Ernst & Young, who, among other topics, presented their views on the findings from the President's Working Group. Following are excerpts from the meeting that focused on valuation and the ramifications of FAS Statements 157 and 157-e on the hedge fund marketplace.

Michael Sleightholme, Managing Director, Hedge Fund Services, North America, Citi: In terms of valuation, is there one thing that hedge funds ought to be doing differently now than in the past?

Arthur Tully, partner and Global Hedge Fund Practice Co-Leader in the Financial Services Office of Ernst & Young LLP: We just went through probably the toughest audit season since I've been involved in the business. And it really was built on what happened last year in terms of security valuations when the markets started to dry up. Then the implementation of FAS 157 made it a bigger hurdle. As funds have gotten more and more complex and are dealing in private equity-type investments, we find that documentation – how funds document their valuation methodology – has become increasingly more significant.

In the old days it was possible for funds to say, "Well, we took a discount; we looked at some comparables." Now, they're going to be asked: "How did you get the discount? Why 10%? Why not 15%? Why any discount? What are your comparables and what makes them valid?" So there is an increased level of work that fund managers have to do day-to-day, and then they need to do additional work to properly document what they've done. The

better the documentation they have, the better off they'll be; the better the policies and procedures are, the better off they'll be. I think the industry's come a long way, but I think there's still a fair amount of work that needs to be done.

One of the other things you're going to see now that you have put FAS 157 disclosures in your financial statements is that investors have a ton of information. They're going to have more information than you do because they're going to see the financial statements for every fund they're invested in, and they're going to have the ability to compare you against every other fund they're invested in. They're going to see your Level 1, Level 2, Level 3 assets; they're going to see how much P&L you've generated off of your Level 3 assets, and that's going to raise questions. If all your P&Ls generate off of Level 3 assets, that's a concern. There are going to be challenges as you think about the information that's out there in the investor's hand and in the regulator's hand.

Sleightholme: Continuing with that topic, what are you seeing in terms of FASB 157 and 157-e, and what are some of the pros and cons for the industry?

Jamie Minkove, executive in the Financial Services Office of Ernst & Young LLP:

FASB Statement 157 established a single definition for "fair value" and a framework for measuring fair value in accordance with GAAP. It also expanded the disclosure about a reporting entity's fair value measurements. However, Statement 157 contemplated an orderly transaction between market participants, not a distressed market. FAS 157-e is intended to clarify how a reporting entity determines whether the market for a financial asset is, or is not, active and thus, whether a sale of that asset is a distressed sale. This was done because FAS 157 did not give as much guidance as we'd like around (1) how to deal with a market that has historically been active and now is inactive, and (2) what happens when the last price, used as the primary basis for valuation, is two or three months old. So what FAS157-e has done is develop a two-step process to help determine what's considered an inactive security.

The first step is to determine whether or not the market's inactive using three criteria: (1) How many transactions have there been, and if there are very few, what does that mean; (2) Price quotes are not current; and (3) Quotes vary dramatically from broker to broker and there are abnormally wide bid/ask prices. Once you've determined that the security is inactive, it's distressed unless usual and customary marketing activities are being performed, and there are multiple quotes for the individual security.

If considered inactive, the fund itself is now responsible for pricing that security. However, this leads to multiple challenges. Because it's your responsibility, you have to come up with a price. Not everybody has the capability to do that. If you are not model-driven or you don't have these techniques, what are you going to do? If you have developed a pricing method, it is going to be challenged – by clients, by auditors, by regulators. Clients and auditors will want to validate how the model is being developed. The people conducting due diligence are going to ask very specific questions around valuation.

Attendee Query: Can you comment on the use of valuation committees by hedge funds?

Tully: Not all of our clients have them, not everyone needs them. The more complex funds have them. Certainly, one of the things you have to look at is where the portfolio manager sits in that valuation committee, and how much power does he or she have over the decision to price the position.

In our recent market research findings, the CFO was the number one choice to be chairman of the valuation committee. That makes sense because the accountants generally get the documentation and are objective about the process. The industry needs to continue to push on and make sure the valuation committees have the right composition, but I think they add a lot of value if properly constructed. Where they fall down a little bit is around the documentation.

Attendee Query: To further that point, what guidelines would you suggest to be a particular level of complexity in order to consider a valuation committee? What directions are coming from the President's Working Group?

Samer Ojeh, principal in the Asset Management practice of Ernst & Young's Financial Services Office: The President's Working Group doesn't specify a particular strategy that would mandate the requirement for a valuation committee. What's happening today is that assets that previously weren't illiquid or hard to value are becoming illiquid and hard to value, so it's up to the fund to decide at what point in the level of complexity it needs to form a committee. It's a blanket statement that a hedge fund is expected to have some sort of a complex product within its portfolio that would require an independent view and governance over how it's being valued. But no specific end strategy has been mandated, especially one that's combined with the relationship with third parties such as a fund administrator. There is a good chance that there will be some discrepancy on what the fund views as the true value of the portfolio versus the fund administrator's view, and having

some sort of a governance model that can interact with the fund administrator and provide the voice of the fund to the fund administrator would be valuable.

Attendee Query: If I'm building a valuation policy, how do I Teflon coat it or how do I reduce the number of red flags? How specific do I have to be if I'm going to write a new policy?

Tully: Valuation shouldn't be so airtight that it can't be adjusted. It's got to be flexible. The key is consistency in how you value the portfolio and the methodology you use. That doesn't mean you can't deviate, but if you do, there's got to be a good reason – some event that occurred that told you it's time to reevaluate your valuation policy. But it shouldn't be hard coded. Under these circumstances, we're going to take a 10% discount; under those, we're going to do a 5%. Valuation methodology should have some flexibility around it that gives you the ability to figure out what that right discount is, or even a multiple premium if necessary.

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