June 21, 2007

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

Re: Consultation Report on Principles for the Valuation of Hedge Fund Portfolios (March 2007)

Dear Ms. Vulpes:

Managed Funds Association ("MFA") appreciates the opportunity to comment on the above-referenced IOSCO Consultation Report ("IOSCO Report"). Apart from providing specific comments to the IOSCO Report, this letter also provides information to IOSCO regarding the role of MFA in representing the interests of the hedge fund industry and to stand as a resource for IOSCO regarding our policy work. These written comments to the IOSCO Report supplement remarks I delivered at IOSCO’s 2007 32nd Annual Conference held in Mumbai, India earlier this year.¹

MFA commends IOSCO on its efforts to provide guidance on the topic of valuation of investments held by hedge funds. MFA generally agrees that a global set of principles in this area is critical given the potential for conflicts of interest between a hedge fund manager and hedge fund investors. MFA acknowledges that the primary goal of the IOSCO Report is to set forth principles to guide hedge fund management in connection with the valuation of their investment portfolios. Overall, MFA generally agrees with these principles and finds that they are, by and large, consistent with MFA’s approach to sound practices in this area, as explained more fully below.


² In this letter, there are references to both “hedge fund management” and “hedge fund managers.” The different usage of these terms is not unintentional. MFA recognizes that the IOSCO Report places primary responsibility on hedge fund management (i.e., the governing body of a hedge fund, a hedge fund manager, or both, depending on the jurisdiction in which a hedge fund is formed) to implement its principles. The intended audience of the IOSCO Report is understandable given that it addresses macro-level principles. MFA’s Sound Practices (as defined below) are, however, addressed to hedge fund managers specifically because MFA’s Sound Practices are focused on day-to-day operational practices of hedge funds.
MFA Background

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media, and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.5 trillion invested in absolute return strategies.

MFA’s activities include several public and private sector initiatives affecting the hedge fund industry in the United States and internationally. With respect to the public sector in the United States, MFA undertakes educational outreach and representation before the Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Reserve, Treasury Department, state agencies and Congress. MFA participates in a number of private sector initiatives, as well. Most notably, MFA has published MFA’s 2005 Sound Practices for Hedge Fund Managers (“MFA’s 2005 Sound Practices”) and is in the process of publishing an upcoming update thereto, MFA’s 2007 Sound Practices for Hedge Fund Managers (“MFA’s 2007 Sound Practices,” and when herein referenced together with MFA’s 2005 Sound Practices, “MFA’s Sound Practices”). Moreover, MFA participates in other private sector efforts, such as working with the 18 major dealers in improving derivative market practices. As highlighted above, MFA also represents the views of the hedge fund industry before international advisory and governmental bodies such as IOSCO, the United Kingdom’s Financial Services Authority, and the Securities Exchange Board of India.

MFA’s Sound Practices & Comments to the IOSCO Report

As stated in my speech in Mumbai this year, MFA believes the nine principles recommended in the IOSCO Report are not inconsistent with the practical recommendations developed for the hedge fund industry in MFA’s 2005 Sound Practices.

By way of background, MFA’s 2005 Sound Practices makes several recommendations for the benefit of the hedge fund industry and covers key topics that are intended to promote sound business practices for hedge fund managers and, in doing so, enhance investor protection while contributing to key market soundness. The recommendations contained in MFA’s 2005 Sound Practices are divided among the following seven topics:

- Management and Internal Trading Controls;
- Responsibilities to Investors;

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3 See www.managedfunds.org.
• Valuation Policies and Procedures;
• Risk Monitoring;
• Regulatory Controls;
• Transactional Practices; and
• Business Continuity and Disaster Recovery.  

At the time of submitting this letter, MFA is in the process of drafting MFA’s 2007 Sound Practices. Publication of this document will continue MFA’s mission of making its recommendations applicable to a broad range of hedge fund managers globally, in light of evolving industry practices. In drafting MFA’s 2007 Sound Practices, MFA is taking into account the latest developments in investment practices by hedge fund managers, as well as the current regulatory environment. It is noteworthy that MFA’s 2007 Sound Practices will reference the U.S. President’s Working Group on Financial Markets’ (“PWG”) “Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital,” published in February 2007. The past and upcoming editions of MFA’s Sound Practices are consistent with public sector calls to improve market discipline. The 2007 Sound Practices will update and expand treatment of topics important to the global hedge fund industry, including internal trading controls, responsibilities to investors, risk management, regulatory controls, transactional practices, business continuity and disaster recovery, and, of course, valuation.

We believe MFA’s Sound Practices are comprehensive and promote standards of excellence for the hedge fund industry. Similar to the IOSCO Report, a central theme emphasized in MFA’s Sound Practices is to stress that “one-size does not fit all” when it comes to evaluating our recommendations to hedge fund managers.

With respect to the subject of this letter, MFA considers the valuation principles recommended in the IOSCO Report as providing macro-level guidance to hedge fund management, whereas MFA’s Sound Practices provides an operational framework of practical recommendations to hedge fund managers. Stated differently, both documents reach the same conclusions, but offer guidance on different levels of detail: one is broader in scope (IOSCO’s principles), while the other focuses on aspirational management that goes beyond any law or regulation and is written from a peer-to peer perspective (MFA’s Sound Practices).

The IOSCO Report requests that public comments to the paper come in the form of responses to seven questions. Accordingly, we have set forth our comments below in the manner requested.

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4 In addition, there are five substantive appendices that supplement the recommendations in the seven substantive areas listed above, which cover: (1) Risk Monitoring; (2) U.S. Regulatory Filings; (3) Anti-Money Laundering; (4) Checklist for Compliance Manuals; and (5) Checklist for Code of Ethics.
1. **What is MFA’s opinion of each of the principles?** MFA concludes that the nine principles are not inconsistent with *MFA’s Sound Practices*. The following discussion addresses each principle specifically.

Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund. *MFA’s Sound Practices* similarly provides that written policies and procedures in terms of valuation is a critical element to achieve consistency, independence and transparency.

The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund. *MFA’s Sound Practices* specifically recommends that where market prices for an instrument are readily available from organized exchanges for markets or recognized data vendors, a hedge fund manager should use such market prices to determine the instrument’s value. In situations where market prices are not readily available, *MFA’s Sound Practices* recommends that a hedge fund manager determine the methods to be used in obtaining values from alternative sources.

The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures. Section 3.2 of *MFA’s 2005 Sound Practices* goes a step further than this principle and provides that a hedge fund manager should seek to utilize valuation practices so that the hedge fund is consistent and fair to both subscribing and redeeming hedge fund investors, to the extent practicable, and makes appropriate disclosures of circumstances in which practices may necessarily deviate from this standard in a material way.

The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness. *MFA’s Sound Practices* agrees with this principle and suggests methods for reviewing valuation policies and procedures based on whether the instrument is actively traded, or is less liquid or infrequently traded. *MFA’s Sound Practices* also suggests that hedge fund managers update valuation policies and practices from time to time, to gauge accuracy and fairness.

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. MFA agrees with this principle in that independence is paramount given the potential for conflicts of interest in the valuation of financial instruments by hedge funds. Specifically, sections 3.3 and 3.4 of *MFA’s 2005 Sound Practices* recommend to hedge fund managers that they develop practices and systems for capturing data from independent sources on a daily basis, where practicable, and that they determine methods to obtain values from alternative sources, with reliability, stability and independence being among the main criteria.
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 manager. Again, MFA’s 2005 Sound Practices agrees with the principle of independence in light of potential conflicts of interest. Section 2.3 of MFA’s 2005 Sound Practices provides that a hedge fund manager should assess whether its operations or particular circumstances may present potential conflicts of interest and seek to ensure that any conflicts of interest that may be material are appropriately disclosed and that controls are in place to address them.

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. MFA’s Sound Practices is consistent with this principle in that MFA’s Sound Practices explicitly recommends that a hedge fund manager fully document the process it uses to determine whether to override a pricing service’s recommendations regarding the valuation of a financial instrument.

The governing body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services. MFA also agrees with this principle and expands it to apply to “mission-critical,” third-party service providers, which perform key business functions (including pricing and valuation). Indeed, sections 1.5 and 3.7 of MFA’s 2005 Sound Practices provide that a hedge fund manager should carefully select third-party service providers based upon their experience and consistently perform diligence to determine if these providers maintain expected levels of service.

The arrangements in place for the valuation of the hedge fund’s investment portfolio should be transparent to investors. MFA’s Sound Practices goes into greater detail than the IOSCO Report with respect to the issue of transparency. In particular, MFA’s Sound Practices provides that a hedge fund manager should provide information regarding the hedge fund’s valuation policies and practices, investment objectives, strategies and range of permissible investments to prospective and existing investors.

2. Has IOSCO correctly identified the challenges inherent in the valuation of hedge fund financial instruments? MFA acknowledges and views as accurate the following five challenges identified in the IOSCO Report, which are faced by hedge fund management relating to financial instrument valuation: (a) the increasing importance of hedge funds to global capital markets; (b) the complexity of some hedge fund portfolio strategies and their underlying instruments; (c) the central role of financial instrument valuations to hedge funds; (d) conflicts of interest that can
exacerbate valuation difficulties; and (e) how the jurisdiction of organization of a hedge fund causes differences in hedge fund strategies.

3. **Has IOSCO correctly addressed those challenges?** MFA commends IOSCO for accurately and adequately addressing the five challenges discussed above. It is our view that hedge funds can use IOSCO’s principles in conjunction with *MFA’s Sound Practices* since both documents are not inconsistent with one another.

4. **In what ways could the principles be amended to further benefit investors in hedge funds?** As mentioned previously, MFA finds that IOSCO’s principles regarding valuation adequately address the challenges discussed above. As the hedge fund industry matures and new questions emerge, it may then be necessary for IOSCO to amend its principles. Nonetheless, MFA feels that the principles as set forth in the IOSCO Report are sound.

5. **Are there material obstacles to the implementation of the principles within hedge funds?** While disparities among hedge fund participants may present a challenge in respect of the application of the principles set forth in the IOSCO Report, MFA does not feel that this rises to the level of a material obstacle, which will prevent their implementation in and acceptance by the hedge fund industry generally. Industry participants vary greatly in terms of the number of personnel, amounts of assets under management and investment strategy. The IOSCO Report, like *MFA’s Sound Practices*, correctly identifies, however, that “one size does not fit all.”

6. **Are there additional principles that would benefit hedge fund investors?** MFA believes that IOSCO’s principles and *MFA’s Sound Practices* provide hedge fund investors with sufficient guidance in which to evaluate for themselves an investment in a hedge fund.

7. **What, if any, additional specific measures should be incorporated within the policies or procedures to enhance the principles?** MFA does not suggest that additional specific measures be incorporated within the policies or procedures to enhance IOSCO’s principles. As mentioned elsewhere in this letter, MFA understands that IOSCO’s principles are intended to provide guidance at a macro-level. If IOSCO were to provide more specific measures or practices with respect to the valuation of financial instruments, this may create conflicts with *MFA’s Sound Practices*, and as a result, cause confusion within the hedge fund industry, which generally accepts and incorporates *MFA’s Sound Practices* in their operations.

As aforementioned, MFA is in the process of drafting *MFA’s 2007 Sound Practices*. While still in its initial drafting phase, the new recommendations applicable to valuation of the hedge fund portfolios will be within the broader context of guiding principles for determination of net asset value. The recommendations in this section will
likely be organized into three key areas. The first set of recommendations will cover verification of financial assets and liabilities, and will include the concept of fair value. The second set of recommendations will cover valuation policies and procedures, including, but not limited to, pricing policies and sources, valuation of instruments and price validation. Finally, the third set of recommendations will address the financial statement close process.

While the three areas discussed in the preceding paragraph are not a comprehensive list of the subjects that will be covered in MFA’s 2007 Sound Practices, we are happy to provide a foreshadowing of what is to come. Once MFA’s 2007 Sound Practices are published, we may take the opportunity to update the comments in this letter.

**Conclusion**

MFA hopes that members of IOSCO’s Standing Committee 5 (of its Technical Committee) and other IOSCO members’ interested in hedge fund industry issues review MFA’s Sound Practices for further guidance. We welcome the opportunity to meet with you and act as a resource of information as you continue to evaluate hedge fund industry issues. For additional information, you may reach me at (202) 367-1140.

Sincerely,

John G. Gaine  
President