TRUST, BUT VERIFY

Investors, Managers Press for Fair Value Transparency

Tom Seltzer

By Chris Franzek

High-profile frauds and a serious economic downturn have led investors to rethink their asset allocations and strive for additional transparency for illiquid or less-transparent investments, some of which previously may have been considered "liquid."

The introduction of Financial Accounting Standards Board Standard 157 (now Accounting Standard Codification Topic 820), which became effective in 2007, put fair value accounting on investors' radar just as the financial crisis catapulted fair value accounting into the center of a media firestorm that alleged at times that the controversial accounting standard was a root cause of the Great Recession.

Whether fair value accounting contributed to the alternative asset industry's challenges over the past two years will be debated for some time. But all signs indicate that fair value accounting is here to stay, and pending regulations are likely to reinforce its continued presence.

Accordingly, investment managers and investors are facing new realities, some of which have direct financial impacts (e.g., valuation) and some of which have indirect impacts (e.g., operations and policies). As a result, investors and investment managers must deal with yet another series of highly complicated issues.

The investors' perspective

As the pendulum of power has shifted from the investment manager to the limited partner, the new mantra for investors in alternative assets has become "Trust, but verify." Gone are the days of investors limiting their diligence process because they feel fortunate to have been granted the privilege of investing in someone's fund.

Operational risk due diligence processes have been improved, and yet there is still great discrepancy in the depth and quality of diligence performed by investors on managers and their independent service providers. Given the breadth of strategies from which an investor may choose and the complexities of some of the underlying investments, it may be nearly impossible for an investor to ask all of the right questions.

Allowing a long-short manager to have a 20 percent carve-out for illiquid investments (at cost) is no longer acceptable. The financial crisis taught many investors that the reports they had trusted so freely may have substantially overstated the fair value of underlying assets. Unfortunately, some discovered this fact upon receipt of an in-kind distribution that was worth a fraction of what their audit statement had proclaimed just weeks before.

If a relatively straightforward long-short strategy can pose such challenges, the more nebulous "event-driven," "special situations" or "distressed" funds are apt to present even more problems. It's likely that many investors should become more actively involved in the investment process, better understand their limitations and make more judicious choices with their money.

Investors have spent more time working to fill in the gaps and, in some cases, rebalance their portfolios to reflect their new-found comfort zone. Independent consultants have been hired, interviewed and referred to help investors gain a greater level of comfort in their underlying managers' policies and practices. Unfortunately, as recently as late November of 2010, SEC inquiries have called into question the quality of some well-known managers' insider trading safeguards, despite some investors believing that one or more of the funds had compliance policies based on "best practices."

Finally, investors have found that Topic 820 also applies to them and that the limited partner positions held in their portfolios are Level 3 assets (e.g., illiquid assets with no significant markets) under Topic 820. Gone are the days of blindly accepting the net asset value (NAV) provided by the general partner (GP) as sufficient for one's personal financial reporting purposes. Investors now have to demonstrate that the NAV provided by the GP has been accurately determined and is "in phase" (as of the investors' measurement date, not as of the GP's measurement date).

This has prompted investors to reach out to GPs for additional transparency, placing significant strains on the fund's investor relations staff (if any exists). As investors go through their year-end audits in early and mid-2011, early returns indicate that GPs should expect greater inquiries from limited partners to help satisfy auditors' demands.

The investment manager's perspective

Several factors are prompting investment managers to improve their internal functions, including the implementation of Topic 820, increased demands for transparency from investors, and looming regulatory changes.

Fund administrators, compliance firms and independent valuation consultants have benefited from the increased demand for transparency. Many investment managers are less than excited to have third parties involved in their processes, especially since most managers mistakenly believe their processes are in line with best practices.

The fact is that many funds aren't adhering to best practices before independent experts suggest that they do so. This justifies the investors' concerns, recommendations and demands. Often there is a transition period as existing practices are improved to fall in line with best practices, frequently under the guidance of a third-party advisor.

It is important to remember that best practices evolve and should be evaluated on a frequent and ongoing basis. For example, broker quotes were formerly accepted as "good" for pricing certain investments (e.g., bank debt). During the financial crisis, many brokers stopped providing indicative quotes or stopped providing them to auditors or fund administrators who relied on them to verify the pricing of a fund's books.

As fewer quotes became available and existing quotes aged, many parties recognized this fact but kept on using the increasingly stale quotes. This widespread problem is receiving more attention as fund administrators and auditors push back on investment managers and urge them to produce more timely data. While some investment managers have unfortunately remained quite passive, others have taken a proactive approach by modifying their valuation policies and procedures or reclassifying some of these securities as Level 3 (under Topic 820) assets.

Gone are the days of INVESTORS *limiting their diligence process.*

As investors go through their audit process, GPs will face additional burdens. This may be less intrusive for hedge fund managers with higher allocations in liquid securities. These managers generally undergo a more rigorous diligence process (initial and ongoing) that includes a detailed understanding of

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Bankruptcy Claims

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still not as standardized as more mature markets, and participants need to be aware of some issues. In particular, there are significant uncertainties in terms of the notional values of claims. Lehman's estate, for example, could object to the value of a claim and reduce its value after it has changed hands.

"The allocation of that risk is one of the biggest tensions between buyers and sellers in the market today," Karp says, noting that in most cases buyers have been insisting on put rights in case the claim shrinks in value, or including language in the contract representations, warranties and indemnification clauses to protect against that instance.

"Many longtime participants in this space would love to have the market believe that markets are standard and that there are no unique issues to be negotiated on a claim-by-claim basis," he says, adding, "But that's not the best way to view it. ■

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the fund's valuation policies and procedures or an interview with the fund's independent valuation provider.

Private equity funds that hold nearly all illiquid securities historically have undergone a much less intrusive diligence process and are already seeing an increase in investor inquiries. This is especially true for larger managers.

Middle market managers are likely to be next, and they are generally short of investor relations staff. The increased demands, therefore, become more onerous. Middle market private equity funds are among the least likely to have a fund administrator or a third-party valuation agent, which may compromise investors' confidence in the validity of the fund's process.

During the past two years, many factors have reinforced the desire for heightened transparency. Investors are enjoying a period of greater influence over GPs and are successfully obtaining greater transparency and comfort because of the presence of third-party advisors. As regulatory authorities around the globe develop and implement new laws, the concepts of transparency and accountability will continue to play important roles in the financial system. ■

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Feed the Hunger

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Launched in December with $15 million, the managers hope to raise $150 million before closing the fund. Mahyar Makhzani, co-managing director of the Sciens Colored Diamond Fund, says because a central clearinghouse for the diamond trade is lacking, the fund plans to also work as an arbitrage fund for diamond dealers.

A former investment banker for the mining trade who asked for anonymity says, "Intermediaries in the diamond business suffer from lack of working capital to buy and hold larger diamonds. Banks have pulled back from providing inventory finance or do so at prohibitive rates."

That's where Sciens sees a value equation. By dangling cash capital, they are hoping miners and diamond cutters will take their cash at a lower price rather than wait for a better deal down the line. Thus, Makhzani's fund can buy at a better price, hold the gem and wait until the market is right to unload at an auction or sell to a lustful collector.

In late 2008, with only a few million, the fund returned 12 percent to a handful of investors. Now with the golden stamp of Sciens' compliance team behind them, fund managers think they can raise more money to take advantage of the arbitrage of bid-offer in the diamond business.

Makhzani is unique because he won't take a performance fee (of 20 percent each year) until all the money in the fund is returned to his investors. That's at least three years away. But with expected returns of 25 to 30 percent, he clearly thinks the fund will reap a profit worth waiting for by being the first mover in this type of fund. ■