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Independent valuation under the regime of the AIFM Directive

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On 22 July 2013, the Alternative Investment Fund Managers Directive (AIFMD) went into force. According to a recent survey, although a majority of member states had already transposed the Directive into law by the deadline, only 12 member states had completed the full legislative transposition. Some regulators, such as the FCA in the UK, have allowed for a transition period extending to July 2014. The Directive imposes far reaching rules that will have a profound impact on AIFM's general operations, and in particular the way they communicate and interact with investors and other stakeholders. While the path to implementation has been wrought with uncertainty and course changes, AIFMD is finally upon us.

An aspect of the Directive that has not garnered the same level of press coverage as other areas of the Directive is the requirement for independent valuations. Addressing investor, auditor and other stakeholder concerns around the issues of subjectivity, transparency and judgment that are inherent in the valuation of illiquid investments is a focal point of the Directive's

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valuation requirements.

A prescription for addressing the independent valuation requirements of the Directive must inevitably start with an understanding of the concept of fair value, its definition, and why this is an area of focus for the European Commission. Fair value, under IFRS 13, is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". For actively traded securities, the determination of fair value is relatively straightforward – it is the prevailing market price – and there is little room for judgement. For securities that do not trade in active markets, however, the determination of fair value requires subjectivity and judgment (as does the determination of what constitutes an 'active market').

Where an AIFM employs subjectivity and judgement, there is the potential for bias. This is not new, and is not isolated to side-pocketed investments in open-ended hedge funds. Concerns over valuation practices amongst closed-ended private equity managers have attracted a steady stream of attention from regulators. For example, the US Securities and Exchange Commission (SEC) began an inquiry in 2011 into the valuation practices of 12 large US private equity managers. And as recently as March 2013 Bruce Karpati, Chief of the SEC Enforcement Division's Asset Management Unit, indicated that the number of cases focusing on alleged misrepresentations of the value of private equity assets will increase.

Regulators aren't the only ones concerned. For limited partners (LPs) to use a fund's reported Net Asset Value (NAV) as the starting point for a fair value estimate of their interest, the LP must satisfy itself that the fund's valuation policies and procedures produce a NAV which is based on a robust determination of the fair value of underlying investments.

The Directive allows valuations to be performed either internally or externally. Whether performing the valuation internally or engaging an 'external valuer', the Directive makes it clear that the AIFM must take steps to ensure that the valuation is "functionally independent from portfolio management". Unfortunately, the framers of the Directive, in their zeal to push independence, failed to consider that completely outsourcing the valuation function is widely viewed as unworkable for at least three distinct reasons: (i) there are obvious limitations inherent in outsourcing key judgments related to valuation to third parties who can never have same knowledge and understanding of the investment as does the fund manager; (ii) AIFMs cannot abdicate their fiduciary responsibility for the assertions included in fund financial statements – in particular the determination of fair value; and (iii) the Directive mandates uncapped liability provisions for an 'external valuer' in many jurisdictions, which could prevent, for economic reasons, the most experienced and knowledgeable external valuers from providing such services.

Even with these limitations, an experienced and independent external valuation adviser can enhance an AIFM's internal valuation procedures to meet the requirements of the Directive and demonstrate a high level of objectivity to LPs.

In our experience, to date only the largest private equity and hedge fund managers have devoted the financial resources to employee in-house valuation personnel who are functionally independent of deal teams. Nevertheless, even such internal valuation resources are often subject to influence from the deal teams. While an internal fair value review committee typically approves valuation estimates, the

Directive ultimately mandates a remuneration policy that ensures that conflicts of interest are mitigated and undue influence on employees is prevented. It remains an open question whether this internal construct fully addresses the independent valuation requirements of the Directive.

Most smaller AIFMs do not have the personnel resources to perform a truly independent in-house valuation, nor the financial means to employee additional personnel with the appropriate level of experience to fully address the requirements of the Directive.

The text of the Directive lays out several specific areas that AIFMs must address, including the following.

First, AIFMs should conduct a review of the key personnel and stakeholders involved in the valuation process with the aim of identifying and mitigating areas of potential conflict and bias. This is likely to be the most disruptive change imposed by the Directive because the current organisational set-up of most AIFMs will likely not comply fully with the Directive. For many AIFMs, the determination of fair value has historically been made by the investment professionals. While the values are approved by a valuation committee, the judgment and subjectivity predominantly lies with the investment professionals. Moreover, in some cases, the 'independent' valuation committee lacks true independence if they have any economic interest in the performance of the manager, whether through carry compensation or otherwise.

Second, AIFMs should revisit their written valuation policy to ensure that it meets the spirit and intent of the independence requirements of the Directive. While virtually all AIFMs have a written valuation policy, many lack the necessary detail in terms of key decision making responsibility. In our experience, the key element in a best-in-class valuation policy document is demonstrating to LPs that valuations are estimated objectively with a robust and thorough process. Moreover, detailed documentation of the AIFM's valuation policy is increasingly a key requirement of many of the world's most prominent LPs, as they have a fiduciary duty to satisfy themselves that the GPs in which they invest have robustly and objectively determined and reported NAV on a fair value basis.

Third, AIFMs should ensure that their writ ten valuation policy sets forth proper valuation methodologies for each asset class in which the AIF invests and amend the valuation policy any time they invest in a new asset class. The Directive states that "since AIFs operate in a dynamic environment where investment strategies may change over time, valuation policies and procedures should be reviewed at least yearly and in any event before AIFs engage with a new investment strategy or a new type of asset".

Fourth, AIFMs should ensure the maintenance of proper documentation of the valuation process on a continuing basis. Best-in-class documentation is not only needed to address the requirements of the Directive, but also for investors and auditors to gain comfort that the AIF's valuation process is robust on a continuing basis (i.e., at whatever frequency at which the AIFM reports NAV to investors). Moreover, for illiquid securities, the valuation documentation should include details on the methodology and data sources relied upon, and the rationale for the use of certain assumptions.

Fifth, AIFMs should set forth a policy governing the use of models, including the creation of such models, the use of data, assumptions and documentation of the rationale for a particular model's use. Furthermore, the AIFM should ensure that there is a policy for approving the use of specific models, and have models validated by an external independent party.

Finally, AIFMs should augment their valuation procedures to ensure that on a continuing basis, they are conducted with independence and objectivity. For some assets, especially complex and illiquid securities, there is a higher risk of inappropriate valuation. According to the Directive, "to address this type of situation, the AIFM should put in place sufficient controls to ensure that an appropriate degree of objectivity can be attached to the value of the AIF's assets". An independent valuation adviser may help to enhance the valuation process and demonstrate independence by supporting and validating the AIFM's fair value determination. From the Directive: "Where the valuation function is not performed by an independent external valuer, the competent authorities of the home Member State of the AIFM may require the AIFM to have its valuation procedures and/or valuations verified by an external valuer or, where appropriate, by an auditor" (Directive 2011/61/EU of the European Parliament and of the Council – Section 2 Article 19).

There is no doubt that uncertainties remain around how the above requirements should be implemented and how regulators will enforce these aspects of the Directive. Given the subjectivity, particularly for illiquid and 'hard-to-value' assets, such uncertainty is accentuated when it comes to the Directive's valuation requirements. What is clear is the Directive's focus on ensuring that AIFMs maintain a level of independence and objectivity in their determination of fair value.

While most AIFMs will continue to rely on input from their investment professionals, the steps outlined above will not only address the requirements of the Directive, but are also prerequisite for investment by many of the world's most prominent LPs. To demonstrate independence and objectivity, an external valuation adviser may be called upon to assist the AIFM in performing a review of their written policy document, and to validate the AIFM's ongoing application of the valuation procedures and conclusions of fair value. ■