

# Asset Management practice point of view

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## The evolving role of the hedge fund administrator in fund valuations: What does the future hold post AIFMD implementation?

Hedge fund administrators must decide whether they wish to fulfil the role of independent 'valuer' and plan for the implications of their decision.

## Current trends in valuation

Smart investors are increasingly interested in understanding the manager's approach to valuation and whether the valuation function is impartial. "Independence" and "transparency" are easily the most employed "buzz-words" of the

moment amongst those involved in the portfolio valuation in light of this emerging attitude. Since the financial crisis, challenges remain in valuing increasingly complex products, derivatives, private equity deals and illiquid securities according to investor expectations. These are pertinent concerns not only for hedge funds, but also for third party hedge fund administrators that hedge funds rely upon for an ever-evolving portfolio of services. Third party independent valuation now represents a significant opportunity for hedge fund administrators who possess the requisite expertise, as hedge funds are increasingly turning to administrators to perform this role.



The “valuer” may be held completely responsible for the portfolio valuation and therefore liable to the AIFM, the AIF or the investors of the AIF for any losses suffered by them as a result of its failure to perform the valuation function, i.e. in the case of NAV errors. The extent of liability borne by the “valuer” may well deter some hedge fund administrators from performing this role.

### Regulatory proposals

The EU has proposed a new Alternative Investment Fund Managers Directive (“AIFMD”) which may become effective from as early as the fourth quarter of 2012. While there has been much focus on the Third Country and Depository provisions, few have really examined certain other proposals such as the requirement for the independent valuation of assets belonging to an alternative investment fund (“AIF”). While it remains to be seen exactly what the implications will be for hedge fund administrators, it seems probable that the AIFMD will allow for the independent pricing function to be performed by the AIFM itself (in a segregated manner) or outsourced to an external “valuer” and that a consistent, disciplined approach to valuation will be required. A more recent draft proposal allows for the appointment of the AIF depository as its ‘valuer’ where certain conditions are satisfied. This article will focus on the implications for hedge fund administrators only however, and potential depository implications are not specifically addressed.

Performing this function internally may be permitted by the regulation, but the set up and maintenance of a separate function including the maintenance of the required “chinese walls” might ultimately prove too onerous and costly on the manager. The expectation is that managers will inevitably require hedge fund administrators to perform the role of independent ‘valuer’. In today’s market environment, managers are keen to outsource functions, both to contain overheads through decreased investment in technology and to allow them to really focus on investment strategy.

In response to investor pressure, several administrators are currently providing largely “independent” valuation of the type specified by the AIFMD. This pricing service may to some extent satisfy the requirements of the AIFMD, although there is a strong possibility that more sophisticated products are not adequately catered for by existing processes.

### Considerations

If a hedge fund administrator chooses to perform the “valuer” role there are a number of considerations:

- The “valuer” may be held completely responsible for the portfolio valuation and therefore liable to the AIFM, the AIF or the investors of the AIF for any losses suffered by them as a result of its failure to perform the valuation function, i.e. in the case of NAV errors. The extent of liability borne by the “valuer” may well deter some hedge fund administrators from performing this role.
- Administrators must carefully consider the costs versus expected benefits of performing this role:
  - Costs associated with bearing this liability in the event of a pricing error;
  - Costs associated with confirming regulatory compliance;
  - Costs associated with providing this service to managers – enhanced validation procedures, expertise, technology and vendor requirements.

- In an increasingly competitive industry, managers hold more power than before, and will expect administrators to provide this service for a competitive price without necessarily passing on all the incremental costs to the manager.
  - The proposed Directive will directly impact EU based AIFM. There is also a potential implication for non EU based AIFM selling their funds within the EU, in terms of equivalency requirements. However, even for those managers not captured by the AIFMD, “independent” valuation is something that investors returning to hedge funds are increasingly expecting and managers will continue to pass this expectation on to hedge fund administrators.
- Understand the views of clients not captured by AIFMD in terms of their best practice valuation requirements.
  - Understand the needs of clients’ clients. Investors insisting on an independent, transparent valuation function prefer to receive related reporting from the hedge fund administrator and this presents an opportunity for new business.
  - Plan strategically for provision of this “valuer” role or an enhanced valuation service while considering the costs of implementation and maintenance, given that re-couping all the associated costs from managers will prove challenging.
  - The terms of the AIFMD will be rules based with specific implementation measures. Hedge fund administrators should be guided by these implementation measures for optimal positioning.
  - It is expected that there will be restrictions over the delegation of the “valuer” role to a non EU country. Hedge fund administrators should bear this in mind when planning to off-shore valuation functions.

### Opportunities and threats for hedge fund administrators

Hedge fund administrators who understand and are able to respond to the new regulatory requirements will be able to assist clients in meeting them and managers will look to those who are ahead of the curve in this respect to service their needs. Although the terms of the Directive are currently still in flux, pro-active hedge fund administrators considering grasping this opportunity should be planning now:

- Keep close to existing clients and seek to understand expectations of potential and re-domiciling clients as the regulation emerges. Will an ability to perform this “valuer” role may be critical to retaining clients and to the success of an RFP?

Proactive administrators are now streamlining the operating model and leveraging technology. They are developing a global operating platform in order to achieve this service level through scale without impacting the cost base. The key differentiating factor for a forward thinking hedge fund administrator will be a strategic approach to providing a valuation service which meets AIFMD requirements for a competitive price and those who achieve this will be at a distinct advantage. Hedge fund administrators need to think strategically about the key considerations should they opt to perform this role, or if they choose not to. They must plan for one course or another – aware of all its implications.

### Contact:

PwC has a well established team of experts based locally and networked globally, offering an unrivalled breadth and depth of experience in the world of valuation. PwC has to date partnered with a number of global and locally based service providers, large and small to optimize strategic performance and valuation service delivery. If you would like any further information or an initial discussion around the implications for your business, please contact our core team.

### Outlook

Currently most administrators are playing a game of “wait and see”. If competitors are positioned to perform the “valuer” role as the regulation emerges, then other hedge fund administrators will be at a distinct disadvantage and must follow suit.

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