STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Administrator Transparency Reporting

SBai Toolbox

Introduction

In the wake of the financial crisis of 2008 and the events, such as the Madoff scandal and the collapse of Lehman Brothers, the investment management sector as a whole has come under increasing investor scrutiny.

The Standards provide a number of safeguards specifically addressing concerns in relation to the safekeeping of assets (Standard 17a.4), independent administration (Standard 17a.5) and valuation (Standards 5-8). As part of their operational due diligence of investment funds, investors nowadays request independent confirmation of fund assets and liabilities by the administrator; they evaluate the fund's pricing sources, and assess the diversification and quality of counterparties. This helps address investor concerns about misappropriation of funds, valuation sources, excessive risk build up vis-à-vis singular/risky counterparties, and shifts in the type of assets (Level I-III) included in the portfolio.

The relevant information can be obtained as part of the net asset value (NAV) calculation process, which is done by the fund's administrator. An increasing number of administrators now provide administrator transparency reports (generally referred to as "ATRs") on a periodic (e.g. monthly or quarterly) basis, thus facilitating investor operational due diligence and ongoing investor monitoring of their investments.

Administrator transparency reports provide independent verification of the following:

1. Net asset value (NAV of the fund and reporting currency), including assets/ liabilities confirmation (reconciliation with custodians, banks, brokers, etc.)
2. Pricing sources (verified using third parties vs. sourced from the manager)
3. Counterparty exposures, asset custody and deposits
4. Asset classification (Level I, II, III)

ATRs exist in different formats and with different levels of granularity, depending on the level of detailed information available at the administrator and the level of detail the investment manager is willing to share. There is also a trade-off between completeness of reporting and "keeping things simple". For a more detailed assessment and aggregation of risk exposures (including counterparty risk), investors should also draw upon the funds' dedicated risk reports.

ATRs should be seen as one of the tools to better understand a fund's risk profile based on independent verification, but they do not replace an investor's due diligence of the manager's processes, safeguards, approaches to deal with conflicts of interest, etc. Also, they do not replace the dedicated risk reporting by the manager which provides a more detailed perspective for ongoing risk monitoring and aggregation purposes.

The SBAI Toolbox is an additional aid to complement the SBAI's standard-setting activities. While alternative investment fund managers sign up to the Alternative Investment Standards on a comply-or-explain basis, the SBAI Toolbox materials serve as a guide only and are not formally part of the Standards or a prescriptive template.

Key points to consider for investors

Examples of issues ATRS can likely flag

- Build-up of large exposures to single counterparties (for single managers and across portfolios of multiple managers)
- Rise in potentially less liquid level III assets
- Increasing proportion of instruments priced by manager
- Changes in unverified assets / liabilities

Examples of issues ATRS cannot address

- In itself, the administrator transparency report cannot identify incorrect valuations, but can provide insight into more subjective areas of valuation that can be further probed
- Risks (conflicts of interests) associated with using an affiliate audit firm to conduct annual audits (e.g. Bayou case)
- Risks (conflicts of interests) associated with using an affiliate administrator (who in turn prepares the administrator report)
- Fake track records
- Structural loopholes (e.g. multi-layered fund structures, where misappropriation/ misevaluations could occur in underlying vehicles)
- Attributing illegitimate expenses to the fund
- Deviations from investment mandate (unless observable in shift of the Level I/II/III asset allocation)
- Sensitivity of the fund to market movements, risk exposure on derivatives

Note: The following ATR template is not formal part of the alternative investment standards.

The SBAI will consult on further standardisation of administrator transparency reports with investors, managers and fund administrators.

Illustration of contents of an administrator transparency report[1]

	Content	Approach/observations
Fund NAV, asset/ liabilities verification	a) Fund NAV • Fund NAV − Assets − Liabilities • Master fund NAV[2] • Offshore fund NAV • Onshore fund NAV b) Breakdown of assets/liabilities: • Verified assets by the administrator • Verified liabilities by the administrator • Un-verified assets (list type of assets)	Independent reconciliation with custodians, (prime) brokers, banks, counterparties, registrars of: • Assets/liabilities in custody • Cash balances • OTC Counterparty balances • Other type of holdings

[1] This illustration is based on observed industry practices. Format, granularity and terminology can vary.

[2] Onshore fund NAV + Offshore fund NAV does not necessarily equate to the Master fund NAV for example due to investments held directly at the feeder level, different fee accruals or small cash balances held at the feeder level.

	Content	Approach/observations
	• Un-verified liabilities (list type of liabilities) • Accruals[3] *All items reported in the fund's base currency.* *Optional percentage breakdown.*	
Pricing sources verification	Value of assets and liabilities by pricing source (in addition optionally in percentage): a) Third party valuation[4] • Independent pricing feed received directly from 3rd party • Third party valuation service provider for Level III assets • Multiple brokers quotes • Single broker quote • Other b) Pricing feed received indirectly from 3rd party (via manager) c) Manager valuation	Gross or net reporting is possible. Appropriate disclosure should clarify which approach is used. Under the EU Alternative Investment Fund Managers Directive (AIFM-D), the value of assets and liabilities priced by the independent External Valuer may be reported separately from the ones not priced by an External Valuer (i.e. the AIFM) of an Alternative Investment Fund (AIF). ***Investor perspective*** *Gross reporting showing assets and liabilities separately preferred, since it avoids unusual results from netting (e.g. a large manager mark asset netting a large manager mark liability).* *Preference for reporting of absolute values (and percentages) rather than just percentages.*
Counterparty exposure & asset custody	List of custodians and counterparties (exposure values or percentage of NAV) Optional break down by exposure type: • Prime Brokers • ISDA • Futures Clearing • Tri-party Account • Centrally cleared OTC • OTC counterparties • Segregated custody account • "Non-custodied" / privately held assets • Affiliate/related party[5] account • Non-Trading Accruals (legal fee, admin fee, etc.)	For business reasons, some managers prefer not to disclose the exact counterparty exposures with individual prime brokers. The following approaches exist to address this: • Providing counterparty exposure ranges per individual prime broker • Providing counterparty exposures in an anonymised fashion (PB1, PB2…) often complemented with a separate list of all counterparties in alphabetical order, thereby enabling investors to get comfortable with the quality of counterparties, without disclosing the exact amount of business with each counterparty ***Investor perspective*** *Investors prefer disclosure of exposures by individual counterparty for risk assessment purposes (including aggregation across multiple funds)* *Preference for absolute values and percentages (rather than just percentages) to*

[3] Usually small, and often already accounted for as part of the verified assets/liabilities bucket

[4] Directly from the respective source (i.e. not via the manager)

[5] Definition of related party: an entity's subsidiary, associates, joint venture interests, directors, close family members of directors

	Content	Approach/observations
	The information is usually provided on a netted basis (see netting approach in Appendix A).	*enable reconciliation to other sources of information.*
Asset classification	Break down of portfolio (assets, liabilities, gross percentage) into Level I, II, III according to IFRS 13 and ASC820 (formerly FAS157) classification.[6] Assets in fund currency (market value, in addition optionally in percentage of NAV or sum of market values): • Level I • Level II • Level III Liabilities in fund currency (market value, in addition optionally in percentage of NAV or sum of market values): • Level I • Level II • Level III *Optional: Include list of instruments.*	The level I, II, III classification is often used as a proxy for "asset liquidity". However, it is important to note that the methodology for classifying assets actually looks at the "certainty of pricing inputs" to derive fair value, and might in some situations not reflect the available liquidity for a given asset/ liability. ***Investor perspective*** • *Reporting in market values is preferable to just reporting percentages* • *Non-netted perspective preferred, i.e. a large Level III liability could otherwise offset a large Level III asset* • *Focus on portfolio of investments, rather than including cash and other items (e.g. accruals) in order to be reconcilable to financial statements* • *Appropriate disclosures should clarify the calculation method for percentages – based on sum of value of positions or NAV*

Recommended frequency: if possible monthly but at least quarterly

Master/feeder structures: For master/feeder structures, the information should be provided at the master fund level, with additional disclosure, if any assets are directly held/invested at the feeder level. Alternatively, the information can be provided at the feeder level with a look through to the master.

Appendix A

Counterparty exposure netting

The financial crisis of 2008 and in particular the collapse of Lehman Brothers have highlighted the need for better understanding of counterparty risk, both for fund managers and investors.

Counterparty risk refers to the risk of one party of a contract not living up to its contractual obligations. It is one of several risks funds routinely encounter in their trading activities. It consists of different risk types (see table), and can, for example, arise in derivative positions and during the settlement process. Counterparty risk is distinct from issuer risk (default of an issuer or borrower), which is not assessed by Administrator Transparency Reports.

Counterparty exposures can be netted, reducing complexity but also resulting in information loss. For example, aggregating assets and liabilities assumes that in a default scenario, only the net exposure is at risk. In OTC derivative markets, legally binding bilateral close-out netting agreements have been put in place to enable exposure netting (e.g. ISDA Master Netting Agreement).[7] However, as seen in the

[6] See fair value measurement definitions at www.ifrs.org (International Financial Reporting Standards/International Accounting Standards Board) and www.fasb.org (Financial Accounting Standards Board)

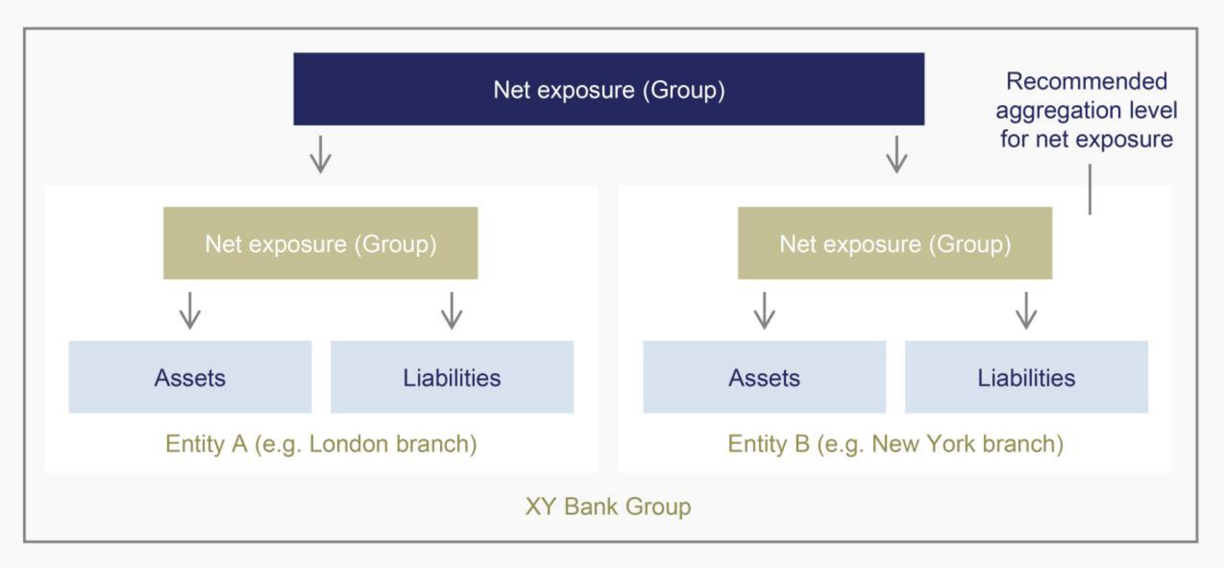
[7] Legal obligations arising from derivative transactions covered by the netting agreement are based on the net exposure of such transactions. Thereby, a defaulted counterparty will not be able to simultaneously default on negatively valued derivative contracts and demand payment on positively valued contracts. Also see "The legal enforceability of the close-out netting provisions of the ISDA Master Agreement (…)" http://www.isda.org/c_and_a/pdf/The-effectiveness-of-netting.pdf

Lehman case, each legal entity within the group is treated separately when the company is placed under the control of insolvency practitioners / administrators.[8] Therefore, it might not be adequate to aggregate exposures across entities within the same group. **The illustration on the right shows the recommended approach for counterparty exposure netting.**

Counterparty risk types	
Default risk	Risk that a counterparty defaults and transaction fails to pay; double default (or wrong-way) risk occurs when collateral is also impaired.
Replacement risk	After a default, risk that replacing deal under same conditions is not possible.
Settlement risk	Risk that party involved in the settlement, such as correspondent bank, fails before transaction has completely settled.

Source: McKinsey Working Papers on Risk, Number 20: Getting to grips with counterparty risk, 06/2010

Counterparty exposure netting



Key points to consider for investors

- Fund administrators do not verify the validity of bilateral close-out agreements when reporting netted exposures
- The netting/aggregation level should reflect the true risk exposures in a default
- Administrator Transparency Reports do not assess the replacement risk

[8] See Lehman Brothers' Administration: FAQ: http://www.pwc.co.uk/business-recovery/administrations/lehman/lehman-faq.jhtml