# The Canada Public Sector Pension Investment Board launches a lawsuit against Saba Capital: Lessons for Fund managers when valuing illiquid securities

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**On September 25, 2015 the Public Sector Pension Investment Board (the "PSP Investment Board") filed a lawsuit before the New York State Supreme Court against Saba Capital, the hedge fund managed by Boaz Weinstein (the former co-chief of the credit business at Deutsche Bank AG), for allegedly "manipulating the value" of certain of Saba Capital's investments. The alleged manipulations occurred in the context of a request of PSP Investment Board for redemption of its entire interest in Saba Capital. This litigation highlights certain inherent risks for hedge fund and private equity fund managers when valuing certain types of illiquid securities.**

### THE SABA CAPITAL LAWSUIT

Saba Capital Offshore Fund, Ltd. (the "Saba Capital Fund"), a hedge fund created under the laws of the Cayman Islands, was formed in 2009. In February 2012 and June 2013, PSP Investment Board invested a total of US$500 million in Saba Capital Fund, making it the largest investor in the fund. Following a substantial decrease in the summer of 2014 in the net asset value ("NAV") reported by Saba Capital Fund, in early 2015, PSP Investment Board decided to request a redemption of 100% of its interest in Saba Capital Fund as allowed by the organizational documents of Saba Capital Fund. At the time, PSP Investment Board's interest in Saba Capital Fund represented approximately 55% of its NAV.

In its complaint, PSP Investment Board alleges that in calculating the redemption price of PSP Investment Board's interest in Saba Capital Fund, Saba Capital Management, L.P. ("Saba Capital Management") marked-down inappropriately the value of fixed income securities issued by The McClatchy Company (NYSE:MNI) held by the Saba Capital Fund (the "MNI Bonds"). This markdown had the effect of reducing the NAV of the fund as at March 31, 2015, resulting in a lower redemption price for PSP Investment Board's Class A shares. According to PSP Investment Board's complaint, the valuation method used by Saba Capital Management for the March 31, 2015 valuation differed substantially from the methods previously used. Further, according to PSP Investment Board less than one month later, Saba Capital reverted back to its previous valuation method, marking-up the value of the same MNI Bonds from their March 31, 2015 valuation. PSP Investment Board also alleges that Saba Capital Management made these abrupt changes in its valuation methods in order to artificially materially depress the value of the MNI Bonds in the calculation of the redemption price of PSP Investment Board's interest in Saba Capital Fund.

The MNI Bonds are illiquid securities. They are neither listed on a national securities exchange nor quoted on the NASDAQ, but are, however, traded over the counter (pink sheets). The lack of a liquid market for a particular type of security makes its valuation very difficult. In this situation, funds will typically rely on prices made readily available by external pricing sources, such as independent pricing services and dealer quotations from market makers or financial institutions regularly engaged in the practice of trading or pricing that security. In its proceedings before the New York State Supreme Court, PSP Investment Board states that in order to value the MNI Bonds, Saba Capital Management had always relied on the pricing provided by these external pricing sources. However, a different method was used in connection with the redemption of the Class A shares of PSP Investment Board.

In this latter case, it rather initiated a bids-wanted-in-competition ("BWIC") process, whereby the MNI Bonds held by Saba Capital Fund were listed with various securities dealers who, in turn, were allowed to makes various bids on them. This process led to depressed bids reflecting a significant liquidity discount from the values previously arrived at under the valuation methods previously used by Saba Capital Fund. The bids obtained by Saba Capital Management were used to value its MNI Bonds, although Saba Capital Fund did not accept any of these bids. As a result, according to PSP Investment Board, the MNI Bonds that were previously valued to 60 cents on the dollar at the end of the 1st quarter of 2015 were valued at 31 cents on the dollar as of March 31, 2015. As a result, the NAV of PSP Investment Board's Class A shares was reduced (the amount of the reduction is not disclosed in the proceedings) and so was the redemption price paid to it.

PSP Investment Board seeks compensatory damages from defendants for an amount to be determined at trial.

## LESSONS FOR PRIVATE HEDGE FUNDS AND PRIVATE EQUITY FUNDS MANAGERS

### TARGETING CONSISTENCY IN THE VALUATION METHODS PRIOR TO REDEMPTIONS

Hedge funds' organizational documents will generally require the manager to perform periodic, usually monthly or, in certain instances, quarterly, valuations of the fund's assets and liabilities. Managers of open-ended private equity funds will usually also be required to produce quarterly valuations of their fund's assets and liabilities.

A fund's manager's compensation will typically be structured so as to foster an alignment of the manager's interest with the interest of all other investors through the carried interest or performance fee it is entitled to receive. However, in the context of a contemplated redemption of interests in the fund, the interest of the manager and the redeeming partner may significantly differ in that while the redeeming partner's interest is to maximize its short-term redemption price, the manager's interest will be to maximize its long-term carried interest or performance fee. The required valuation of the fund's assets and liabilities to determine the price payable to the redeeming partner will have a direct impact on the proceeds received by the redeeming partner, as was the case with PSP Investment Board. This conflict and, consequently, the risk of ensuing litigation is exacerbated by the fact that the valuation of the fund's assets and liabilities is carried out as a going concern, without the fund being actually liquidated.

For this reason, fund managers should try to avoid, as much as possible, using a method of valuation for the purpose of determining the price to be paid to the redeeming investors that is different from the method ordinarily used in the past. It will be difficult for a redeeming investor to assert that the manager has been manipulating the valuation of the fund's assets for the purpose of reducing the redemption price of its interest if the valuation method used by the manager has been used consistently and reported periodically to the investors without any issue.

A liquidity shock caused by the sudden request for redemption of an important investor or other particular circumstances (such as the acquisition of newly-created instruments) may, however, prevent the manager, in order for it to be fair and equitable to all investors, to continue using the valuation methods employed in the past. In cases where conditions supporting previous valuations have changed, the manager should engage with investors to ensure consensus on the fairest valuation method in the new circumstances. This may however not be possible or even desirable after receipt of a redemption request as the immediate pecuniary interest of the redeeming investors may make a consensus impossible to achieve.

## ADOPTING A SEPARATE VALUATION POLICY

The valuation methods intended to be followed by the manager of an hedge fund or private equity fund will typically be described in organizational documents and the offering or private placement memoranda of such hedge fund or private equity fund. However, they will generally be limited to a high level overview of how the manager intends to actually proceed to value the fund's assets and liabilities.

While this level of flexibility is welcomed by managers to prevent having to amend organizational or offering documents frequently (which can involve significant costs), it can lead to conflicts such as the one between PSP Investment Board and Saba Capital Management, especially if the procedure followed by the manager varies over time with respect to a certain type of assets.

Having a formal valuation policy in place (separate from the organizational and offering documents so that it can be amended without requiring significant costs for the fund and the investors) providing for a more detailed description of the valuation procedures followed by the manager would therefore be a best practice for hedge fund and open-ended private equity fund managers. This valuation policy should remain available for review by existing and potential investors. The disclosure on valuation contained in the offering documents should cross-reference the policy to ensure that all investors are aware of its existence. It should further specify that a copy can be obtained upon request. The manager should also review the valuation policy periodically to ensure that it still adequately reflects the process currently followed by the manager.

The valuation policy should describe in details the valuation methods that the manager will use for each type of instrument or securities. The policy should also state the external pricing sources intended to be used by the manager, if any, the hierarchy between these pricing sources and, if possible, the accepted tolerance levels for any discrepancies between different pricing sources. It should further clarify how exceptions, if any, will be managed.

Moreover, if the manager intends to use certain unusual types of valuation practices, they should be specifically provided in the organizational documents. For example, in order to prevent potential lawsuits from the fund's investors, if the manager intends to "side-pocket" certain illiquid or hard to value securities, it should be allowed do so only if its use is specifically authorized by the fund's organizational documents. A simple reference to "side-pocketing" in the valuation policy may not offer a sufficient protection.

## CONCLUSION

The above recommendations are only a few of the best practices that can be put in place in connection with the valuation of illiquid securities and, in any event, do not guarantee that investors will not challenge, by litigation if necessary, the manager's valuation of these securities. Indeed, in PSP Investment Board's case, Saba Capital Management filed a motion to dismiss alleging that "[T]he valuation process PSP describes in its complaint is entirely consistent with the governing documents—indeed, they required it under the circumstances". As the case was referred to mandatory mediation by the New York Supreme Court in early October 2015, Saba Capital's motion to dismiss has not yet been decided. Nevertheless, following the above recommendations should decrease the risk of litigation relating to the valuation of certain type of securities and offer significant protection in case of litigation.