MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

24 March 2023

# MFSA's Findings and Observations Identified During the ESMA Common Supervisory Action on Valuation of UCITS and Open-Ended AIFs

## 1.0 Background

On 20 January 2022, the European Securities and Markets Authority ("**ESMA**") launched a Common Supervisory Action ("**CSA**") with National Competent Authorities ("**NCAs**") on Valuation of Assets and targeted UCITS Management Companies ("**UCITS ManCos**") and Alternative Investment Fund Managers ("**AIFMs**") inclusive of self-managed structures (collectively "**Fund Managers**"). In particular, the CSA focused on UCITS and open-ended AIFs that invest in less liquid assets such as: unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, emerging markets, illiquid listed equities, and bank loans.

The CSA was performed throughout 2022 based on a common assessment framework developed by ESMA for EU/EEA regulatory authorities that aimed to assess the extent to which regulated entities comply with valuation-related provisions under Directive 2009/65/EC ("**UCITS**") and Directive 2011/61/EU ("**AIFMD**"), as further transposed in Part BII of the Standard Licence Conditions applicable to Investment Services Licence Holders which qualify as UCITS Management Companies and Part BIII of the Standard Licence Conditions applicable to Investment Services Licence Holders which qualify as AIFMs ("**the Rules**").

Based on the above, the MFSA circulated a standard questionnaire ("**CSA Questionnaire**") to a pre-selected sample of Fund Managers, seeking information relating to the valuation of assets. A limited number of Fund Managers within this sample were also identified to be in scope of a thematic compliance inspection based on the level II and III assets within their funds' investment portfolios, enabling the MFSA to acquire a better understanding of valuation processes adopted by Fund Managers with regards to less liquid assets. Additional supervisory interactions were also held with all Fund Managers after the submission of the CSA Questionnaire with a view to obtain further information or clarifications.

The MFSA assessed the level of compliance of Fund Managers with the valuation related requirements enshrined within the Rules and concluded that, while the overall level of compliance with the applicable regulatory requirements was satisfactory, certain gaps and improvements in some crucial areas remained. The aim of this Circular is to make the Fund Management industry aware of the Authority's findings and observations and provide the Authority's supervisory expectations.

## 2.0 Findings and observations

### 2.01 Governance Structures

The MFSA observed that governance structures varied across Fund Managers based on the asset classes, frequency of valuation decisions as well as the availability of in-house expertise. In this regard, the Authority identified certain weakness that called into question the robustness of the governance arrangements in place. In particular, some fund managers failed to formalise all the roles and responsibilities and reporting lines of those involved within the valuation process, leading to a lack of clarity about who was responsible for which valuation tasks and whether the valuation process remained sufficiently independent from the portfolio management function and the remuneration policy.

Robust organizational structures are essential to ensure compliance with the obligation to perform an independent valuation of assets, as outlined in the SLC 2.25 of Part BIII of the Rules (AIFMs) as well as SLC 3.18 of Part BII of the Rules (UCITS Managers)[1]. Fund managers should aim to conduct regular reviews of their governance setup surrounding the valuation of assets and make the appropriate arrangements to close any identified gaps. Please note that the responsibility to ensure an adequate setup for the valuation of assets ultimately rests on the Fund Manager's Board of Directors.

### 2.02 Oversight of Illiquid Assets

A recurring finding that was identified during the MFSA's thematic inspections was the apparent lack of assessments and probing by the Board with respect to valuation risks emanating from less liquid assets, including liquid assets whose prices had been stale for an extended period.

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[1] SLC 2.25 of Part BIII of the Rules (AIFMs) states "*The Licence Holder shall ensure that the valuation function is either performed by:*

> a. *An external valuer, being a legal or natural person independent from the AIF, the Licence Holder and any other persons with close links to the AIF or the Licence Holder;*
>
> b. *The Licence Holder itself, provided that the valuation task is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon employees is prevented."*

SLC 3.18 of Part BII of the Rules (UCITS Managers) state (…)

*"The Licence Holder shall ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS it manages, in order to comply with the duty to act in the best interests of the unit-holders. The Licence Holder must be able to demonstrate that the UCITS portfolios have been accurately valued."*

The Authority would like to emphasize that the Board's responsibility does not end with the approval of the Valuation Policy and Procedures document (including valuation methodology), but also includes monitoring the procedures' implementation and overseeing the valuation process, especially in relation to illiquid assets. While Board members will not be performing the valuation tasks themselves, it is critical that Directors have a broad grasp of the inputs that go into valuing Level III assets and they understand the underlying valuation risks within their funds' portfolios to be in a position to challenge valuation methodologies where appropriate.

To this end, Board members should have appropriate awareness of valuation risks of assets that are less liquid by nature and assets that became illiquid as a result of other particular circumstances. The follow-up of these risks should be closely monitored by the Board, in particular during stressed market conditions. Any pricing signals resulting from changing market dynamics should be appropriately considered to ensure that the valuation methodologies, as implemented within the valuation policy, remain appropriate.

**2.03 Valuation updates**

In some cases, valuation updates merely ensured whether there were valuation issues during the period and occasionally lacked sufficient justifications and explanations of such issues.

Accordingly, the Valuation Function should ideally provide the Board with an overall update on the valuation of each fund, including, but not limited to, the composition of the respective sub-funds' portfolios in terms of fair value hierarchy, valuations obtained from a single source or counterparty, large price movements, stale positions, and positions valued using sources other than those stipulated in valuation policy.

Additionally, the Board should also ensure to set the type and frequency of valuation updates that it should receive and aim to be provided with a qualitative and actionable narrative of any concerns and actions taken to mitigate any valuation risks identified during the valuation process.

Where applicable, the valuation committee should also report its conclusions and recommendations to the Investment Fund Manager's Board of Directors and, where relevant, the fund's Board, on a periodic basis

**2.04 Valuation Policies and Procedures**

During the supervisory interactions held with Fund Managers, the MFSA discovered instances where Fund Managers relied on the valuation disclosures within the offering documentation of the funds and had no formally documented valuation policies and procedures in place. The MFSA also identified several shortcomings in fund managers' valuation processes that are not in line with SLC 2.10(b) of Part BII of the Rules and SLC 2.17 of Part BIII of the Rules[2].

Given the extent of shortcomings in relation to the valuation policy of various Fund Managers, the Authority would like to provide a basic indication of the areas that require further enhancements:

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| **Roles and Responsibilities** | The MFSA noted that the roles and responsibilities of the Directors, Valuation Officer/Valuation Committee, external valuers and external advisers were not clearly defined, within the valuation policies and procedures. |
| **Pricing Methodologies – Liquid Assets** | Pricing methodologies were mostly provided in a narrative and supplemented with a pricing source hierarchy. In some exceptional cases, they only included one pricing source or had several pricing sources with no clear hierarchy. |
| **Pricing Methodologies – Less Liquid Assets** | In most cases, the valuation policies and procedures provided the Fund Manager with discretion on whether to appoint an external valuer or develop an internal model-based valuation model.<br><br>However, no additional details or references to other policies and procedures were provided in relation to the process for (a) selecting an internal |

[2] SLC 2.10(b) of Part BII of the Rules states: "*The Licence Holder shall establish appropriate procedures to ensure the proper and accurate valuation of the assets and liabilities of the UCITS, as consistent with the Investment Services Rules for Retail Collective Investment Schemes on valuation of assets*".

SLC 2.17 of Part BIII of the Rules states: "*The Licence Holder shall ensure that for each AIF it manages, appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed in accordance with SLCs 2.17 to 2.33, the fund rules or the instruments of incorporation.*"

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| | valuation model (b) selecting an external valuer and (c) the validation of a model-based valuation. |
| **Departure from the pricing methodology/ pricing exceptions** | Valuation policies and procedures lacked documentation of how exceptions to pricing methodology are handled, approved and documented. |
| **Pricing Differences** | Some Fund Managers did not have a formal procedure for identifying and escalating price differences, including the establishment of a threshold above which valuations are required to be reviewed and resolved by the valuation function prior to escalating such differences to the Fund Manager's Board of Directors for discussion and/or approval of any pricing exceptions. |

**2.05 Early Escalation Mechanisms**

Early mechanisms and procedures to detect valuation errors mainly encompassed controls set up by the Fund Administrators, which included the escalation to the Fund Manager when any unusual valuation discrepancy at the financial instrument level is identified during the NAV calculation.

Based on the resources available, some Fund Managers additionally performed independent price reconciliation checks prior the approval of the NAV pack provided by the Fund Administrators. Such checks ensured that any major valuation issues were detected early and that preventive actions were taken to avoid any negative impact on investors as a result of the error.

In this respect, the Authority noted that some Fund Managers did not have formal policies and procedures laying down the price reconciliation process. The Authority also noted that most fund managers do not have a formal process for compensating investors in case of NAV and valuation errors.

The MFSA considers it essential for Fund Managers to address the valuation risks faced by AIFs and UCITS in a proactive manner. Formal processes are therefore considered important for Fund Managers to ensure prompt activation of such measures and that formal remedial procedures are in place in the event of incorrect calculations of NAV and valuation errors.

**2.06 Validations of Model Based Valuations**

The type of validation approach taken by Fund Managers included; verifications with proxy models, checks on the correct input of prices from official agreements made with the fund, and checks on whether parameters used were in line with industry standard models such as the rules of the International Private Equity and Venture Capital Valuation Guidelines (“**IPEV**”)[3] and the valuation standards and principles set out by the Royal Institute of Chartered Surveyors (“**RICS**”)[4].

The annual audit of the fund's financial statements was also noted to be informally used to validate certain assumptions of an accounting nature. That said, the Authority observed that there was still a general lack of clarity within the valuation policies and procedures on who performed the validation tasks. Fund Managers also appeared to rely on the external auditors to perform a review of any non-financial assumptions without providing sufficient justifications on whether the external auditor had sufficient expertise to carry out such a review.

Although involving the fund's external auditors in the verification of valuation models is acceptable, especially given the resources available to the Fund Manager, the nature and size (in terms of % NAV) of the relevant assets may have necessitated additional validations at pre-determined frequencies.

The Authority considers that periodic validation of valuation models is critical, especially considering the susceptibility of certain models to subjectivity and judgement, which poses a considerable risk of inappropriate valuation. Fund Managers are expected to perform appropriate checks, controls and back testing on a regular basis and be able to demonstrate that such checks have been completed. The frequency of these validations, as well as the associated checks/tests, should be determined in line with the nature of the Fund's investment portfolio.

[3] The International Private Equity and Venture Capital Valuation (“IPEV”) Guidelines set out recommendations, intended to represent current best practice, on the valuation of Private Capital Investments.

[4] The Royal Institution of Chartered Surveyors (“RICS”) is a recognised professional body responsible for developing professional valuation standards internationally and in Europe.

### 2.07 Due Diligence on External Valuers

Fund Managers that engaged external valuers conducted due diligence on such firms in accordance with the applicable regulatory rules, particularly those pertaining to independence, professional registration and guarantees[5], as well as the necessary skills and resources to perform the valuation of an asset.

With respect to professional guarantees, the MFSA noted that while such guarantees were provided in the engagement letter and service level agreements with external valuers when originally engaged, no confirmations were requested on an ongoing basis. In this regard, the MFSA considers that it is good industry practice for Fund Managers to request confirmations from external valuers periodically through periodic declarations.

As regards conflicts of interest arising from such outsourcing arrangements, the MFSA noted that most Fund Managers had no specific controls implemented to manage and mitigate conflicts of interests in this area. However, certain best practices were observed by the Authority that were considered to contribute to a more robust conflicts of interest framework in relation to outsourced functions, including specific procedures within the conflict-of-interest policy, specifying the potential conflicts that could arise and the necessary controls to keep conflicts in check such as pre-defined mitigation measures, escalation, and reporting channels.

### 2.08 Appointment of External Valuers

The MFSA encountered several cases where Fund managers failed to inform the Authority of an appointment of an external valuer. The fact that the MFSA was notified after the Fund Manager appointed the external valuers is not compliant with SLC 4.01 of Part BIII of the Rules and/or SLC 2.5(i) of Part BII of the Rules[6].

### 2.09 Ongoing Monitoring

The MFSA found that while Fund Managers had a compliance monitoring plan that covered several compliance checks on valuation controls, some lacked in providing sufficient detail of the checks/tests relating to the valuation process or did not include a review of key

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[5] Fund managers have the obligation to obtain written professional guarantees when delegating the valuation to an external valuer, as outlined in Article 19(b) of the AIFMD. These guarantees must contain evidence of the valuers' qualifications and capability to perform proper and independent valuations, as well as evidence of sufficient personnel and technical resources, adequate procedures, adequate knowledge and understanding of investment strategies and asset classes, and a sufficiently good reputation and experience with valuation.

[6] SLC 4.01 of Part BIII of the Rules states that "*A Licence Holder which intends delegating to third parties the task of carrying out functions on its behalf shall notify the MFSA before the delegation arrangements become effective*".

*SLC 2.5(l) of Part BII of the Rules states that "the Manager is to obtain the MFSA's prior consent to the outsourcing or delegation of any of its functions following submission of appropriate details as may be required by the MFSA";*

requirements emanating from the Rules, the UCITS Directive and the AIFMD, sometimes leading to cases where requirements were not being checked and effectively complied.

## 3.0 Concluding Remarks

The MFSA submitted its final report to ESMA in December 2022. In the meantime, bilateral engagements were held with Fund Managers in relation to the deficiencies identified during the CSA exercise, requiring the implementation of corrective measures to address any deficiencies.

Considering our findings, remarks, and guidance, Fund Managers should assess their own governance structures, processes and procedures and take the necessary steps to address any deficiencies in line with the applicable regulatory requirements and the strategies and objectives of the funds under management. It is critical to set-up valuation policies, procedures and practices in line with the nature of the fund and to avoid a one size fits all approach.

The Authority shall continue its supervisory work in the area of valuation in future supervisory interactions to assess the level of compliance of Fund Managers with the applicable requirements, particularly to assess whether the indicated shortcomings and guidance provided in this Circular, have led to an increase in the robustness of internal controls of Fund Managers. The Authority does not exclude the possibility of taking appropriate regulatory action in case of any significant lack of progress by Fund Managers to have in place adequate controls and governance arrangements in this area.

## 4.0 Contacts

Any queries in relation to this Circular are to be addressed to funds@mfsa.mt.