FINANCIAL REGULATOR
Rialtóir Airgeadais

Guidance Note 1/00

Valuation of Assets of Collective Investment Schemes

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Assistance Paper

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Paragraph 2 of non-UCITS Notice NU 8 provides:

" *The assets of a collective investment scheme, including any techniques or instruments used for the purposes of efficient portfolio management (Ref. NU 16), will be valued by a method clearly defined in the trust deed, deed of constitution, articles of association or partnership agreement and approved by the Financial Regulator. The method of valuation used will be disclosed in the prospectus."*

Paragraph 2 of UCITS Notice UCITS 5, provides:

" *Unless otherwise provided for in the trust deed, the deed of constitution or the articles of association, the value of the assets of a UCITS shall be based, in the case of securities traded on a stock exchange or on a regulated market, on the last known stock exchange or market quotation unless such quotation is not representative. For securities not so quoted and for securities which are so quoted but for which the latest quotation is not representative, the value shall be based on probable realisation value which must be estimated with care and in good faith. Financial derivative instruments will be valued by a method clearly defined in the trust deed, the deed of constitution or the articles of association."*

The Irish Financial Services Regulatory Authority ["the Financial Regulator"] reviews valuation provisions contained in the trust deed, deed of constitution, articles of association or partnership agreement during its assessment of an application. This note provides guidance on the Financial Regulator's application and interpretation of the above conditions. As a fundamental principle, valuation methodologies and the pricing of units must strive to promote fair treatment of incoming, existing and outgoing investors in collective investment schemes ("CIS").

1. Methods of Valuation

Valuation policy will be established by the management company, investment company or general partner. A CIS is required to ensure that the valuation rules provided are clear and unambiguous. While a CIS is not required to follow a particular set of valuation rules, valuation policies should fall within the parameters set out below. Other valuation policies may be permitted provided that an acceptable rationale is provided to the Financial Regulator, the methodology is clearly disclosed and it is not in conflict with relevant legislation or the principles outlined herein.

Assets may be valued in accordance with the following guidelines:

a) Securities which are listed or traded on a regulated market:

- Valuation should be the closing or last known market price. The CIS may determine that this shall be the closing bid, last bid, last traded, closing mid-market or latest mid-market price.[1]
- Where a security is listed on several exchanges, the relevant market shall be the one
  - which constitutes the main market, or
  - the one which the manager/directors/general partner determines provides the fairest criteria in a value for the security.
- Securities listed or traded on a regulated market, but acquired or traded at a premium or at a discount outside or off the relevant market may be valued taking into account the level of premium or discount at the date of the valuation. The trustee must ensure that the adoption of such a procedure is justifiable in the context of establishing the probable realisation value of the security.

b) Securities which are listed or traded on a regulated market where the market price is unrepresentative or not available and unlisted securities:

- The value of the security is its probable realisation value which must be estimated with care and in good faith.
- The security may be
  - valued by the manager, directors or general partner, or

[1] It may be more appropriate to use an offer price or offer quotation in certain circumstances (e.g. to value a short position or in the context of a dual pricing CIS (see Note (iv) below).

- valued by a competent person[2] appointed by the manager, directors or general partner and approved for the purpose by the trustee, or
- valued by any other means provided that the value is approved by the trustee.

▪ Matrix pricing (i.e. valuing securities by reference to the valuation of other securities which are considered comparable in rating, yield, due date and other characteristics) may be an appropriate method of valuation for fixed income securities, where reliable market quotations are not available. Provision may be made for matrix pricing provided the securities used in the matrix are comparable to the securities being valued. Matrix pricing must not ignore a reliable market quotation. The matrix methodology will be compiled by the manager, directors, general partner or competent person, as outlined above.

c) Collective investment schemes:

▪ Valuation is based on the latest bid price or latest net asset value, as published by the collective investment scheme.
▪ Use of a mid or offer price is acceptable if consistent with valuation policy, i.e. the other assets held by a CIS should be valued on the same basis.
▪ Use of market prices may be appropriate where the collective investment scheme in which the investment is made is listed on a regulated market, in accordance with (a) above.

d) Cash (in hand or deposit):

▪ Value is the nominal/face value plus accrued interest

e) Exchange traded futures and options contracts, including index futures:

▪ Valuation is based on the settlement price as determined by the market in question. If a settlement price is not available they may be valued in accordance with (b) above.

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[2] Where the "competent person" is a related party to the CIS, the prospectus should disclose the possible conflict of interests which may arise (e.g. valuation provided by an investment adviser; the advisers fee will increase as the value of the CIS increases)

f) Over-the-counter derivative contracts:

- The Financial Regulator's Notices, both UCITS (UCITS 10) and non-UCITS (NU 16, NU 20, NU 21), require that the counterparty to an over-the-counter ("OTC") derivative contract must be prepared to value the contract and to close out the transaction at the request of the CIS, at fair value[3].
- A CIS may choose to value an OTC derivative using either the counterparty valuation or an alternative valuation, such as a valuation calculated by the CIS or by an independent pricing vendor provided the CIS or other party has adequate human and technical means to perform the valuation. A UCITS must value an OTC derivative on a daily basis; non-UCITS must value on a weekly basis[4].
- Where a CIS will value an OTC derivative using an alternative valuation:
  - the Financial Regulator expects that the CIS will follow international best practice and adhere to the principles on valuation of OTC instruments established by bodies such as IOSCO and AIMA;
  - the alternative valuation is that provided by a competent person appointed by the manager, directors or general partner and approved for the purpose by the trustee, or a valuation by any other means provided that the value is approved by the trustee; and
  - the alternative valuation must be reconciled to the counterparty valuation on a monthly basis. Where significant differences arise these must be promptly investigated and explained.
- Where a CIS will value an OTC derivative using the counterparty valuation:
  - the valuation must be approved or verified by a party who is approved for the purpose by the trustee and who is independent of the counterparty[5];
  - the independent verification must be carried out at least weekly in the case of UCITS and at least monthly in the case of non-UCITS.[6]

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[3] For the purposes of this paragraph, the reference to fair value shall be understood as a reference to the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

[4] The Financial Regulator will permit closed-ended CIS and/or PIF and QIF CIS to value OTC derivatives on a monthly basis.

[5] An independent party can include the CIS. It can also include a party related to the OTC counterparty provided that the related party constitutes an independent unit within the counterparty's group, which does not rely on the same pricing models employed by the counterparty. In this case, the relationship between the parties, and the attendant risks, must be disclosed in the prospectus. In the case of UCITS and retail non-UCITS, where the independent party is related to the OTC counterparty and the risk exposure to the counterparty may be reduced through the provision of collateral, the position must also be subject to verification by an unrelated party to the counterparty, on a six monthly basis.

[6] A CIS which is permitted to value OTC derivatives on a monthly basis (see footnote 4) must carry out the independent verification procedure at least on a quarterly basis.

g) Forward foreign exchange and interest rate swap contracts:

- Valuation of these OTC derivative contracts can be in accordance with the preceding paragraph or, alternatively, by reference to freely available market quotations. If the latter is used, there is no requirement to have such prices independently verified or reconciled to the counterparty valuation.

Notes:

(i) Additional provision for specific asset:

A trust deed, deed of constitution, articles of association or partnership agreement may provide that, notwithstanding the detailed valuation rules, valuation of a specific asset may be carried out under an alternative method of valuation if the manager, directors or general partner deem it necessary. The alternative method of valuation must be approved by the trustee and the rationale/methodologies used should be clearly documented.

(ii) Adjustments:

The value of an asset may be adjusted by the directors, manager or general partner where such an adjustment is considered necessary to reflect the fair value in the context of currency, marketability, dealing costs and/or such other considerations which are deemed relevant. The rationale for adjusting the value must be clearly documented.

(iii) Amortised cost:

A CIS which is a money market fund is permitted to provide for the use of amortised cost as an alternative method of valuation in accordance with Guidance Note 1/08.

It is recognised that there are non-money market CIS which have investments in money market instruments. Where it is not the intention or objective to apply amortised cost valuation to the portfolio as a whole, money market instruments within such portfolios may be valued on an amortised basis provided that the money market instruments have a residual maturity of less than three months and have no specific sensitivity to market parameters, including credit risk.

In the case of non-UCITS CIS, amortised cost may also be applied to money market instruments with a residual maturity not exceeding six months, where these instruments have no specific sensitivity to market parameters, including credit risk.

(iv) Dual pricing:

A trust deed, deed of constitution, articles of association or partnership agreement may provide for the calculation of a separate bid and offer price on its units, i.e. dual pricing. The valuation procedures utilised in calculating both the bid and the offer price should be clearly disclosed as previously outlined.

(v) Consistency:

A CIS may provide for valuation of its assets on a mid-market basis, a bid basis or, in the case of dual pricing, on a bid and offer basis. It can also provide for valuations on an offer basis where total subscriptions on a dealing day exceed total redemption requests, or for a switch from mid-market to bid basis when total redemption requests, on a dealing day, exceed total subscriptions. Valuation policies, including provisions which allow for a switch from a mid-market to a bid or offer basis, must be applied on a consistent basis throughout the life of the CIS.

Whatever basis is chosen, there must also be consistency in the policies adopted throughout the various categories of assets. Accordingly, if a switch to valuation on an offer basis is provided for in one category (because of subscriptions exceeding redemptions) then the other categories must contain the same provision. There may be some exceptions to this principle because an offer quote is not available.

(vi) Dealing:

Dealing in the units of a CIS should be carried out at forward prices i.e. the Net Asset Value next computed after receipt of subscription and redemption requests.

2. Frequency of Valuation

The assets of a CIS must be valued, and units priced, at regular intervals. The longest permitted intervals between such valuations/pricing of units are as follows:

- **UCITS:** Fortnightly basis
- **Non-UCITS retail schemes:** Monthly basis[7]
- **Professional /Qualifying investor schemes:** Quarterly basis

3. Responsibility

a) Management company, directors, general partner:

Ultimate responsibility for valuations rests with the management company/ directors/general partner.

- The management company/directors/general partner should ensure that securities prices and currency rates are up to date and are provided from a reputable source. The reliability of the source of prices and rates should be kept under constant review.
- Systems and procedures should be in place to:
  - verify uncertain prices and rates;
  - ensure that investment restrictions are not breached;
  - ensure that dividends, expenses and taxes are properly accounted for;
  - provide movement thresholds at which price movements are reviewed;
  - query prices which appear stale, i.e. little or no movement over time;
  - provide for the valuation policy in relation to unlisted or illiquid securities;
  - provide for the valuation policy in relation to OTC derivatives.
- Full and detailed records, particularly in the case of unlisted or illiquid securities and OTC derivatives, should be maintained where they can be reviewed. The management company, directors or general partner should pay particular attention to and closely monitor valuations provided by parties in respect of illiquid or unlisted securities and OTC derivatives to ensure that they remain competent for this purpose.

[7] Under the NU Series of Notices (NU 14, NU 18), venture capital and property schemes may be established where dealing is carried out on a half-yearly basis. These CIS are generally viewed and established as closed-ended schemes however. Their valuation policies are required to reflect appropriate standards for valuation of venture capital and property type investments. Moreover the Financial Regulator's Notice on property schemes requires the appointment of an independent valuer.

- Reconciliation of cash, debtors and creditors should take place at a frequency which reflects the frequency of the valuation.

b) Trustee

The Financial Regulator’s Notices [UCITS 4 and NU 7] require the trustee to ensure that the value of units is calculated in accordance with the Regulations and/or the trust deed, deed of constitution, articles of association or partnership agreement, as appropriate.

- The trustee should ensure that the valuation methodologies provided for in the constitutional documentation are adhered to and the operations of the management company/investment company/general partner are properly controlled.
- A detailed initial review of the overall valuation procedures should be carried out and these should be subject to subsequent periodic review by the trustee. The frequency of the periodic review should depend on the type of CIS and the degree of satisfaction with the initial review.
- Careful attention should be given to procedures adopted in the case of illiquid or unlisted securities and OTC derivatives.

FINANCIAL REGULATOR
Rialtóir Airgeadais

PO Box No 9138
College Green,
Dublin 2, Ireland

T +353 1 410 4000
Consumer help-line
lo call 1890 77 77 77
Register of Financial Service Providers help-line
lo call 1890 20 04 69
F +353 1 410 4900
www.financialregulator.ie
www.itsyourmoney.ie
Information Centre: 6-8 College Green, Dublin 2