Thematic review of the valuation of UCITS and non-UCITS investment funds' assets

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1 Background, objectives and conclusion of the thematic review

1.1 Background of the thematic review

In the first half of 2022, the Financial Supervisory Authority (FIN-FSA) conducted a thematic review concerning the valuation of the assets of UCITS and alternative investment funds (AIFs) (hereinafter also investment funds). The thematic review was part of a Common Supervisory Action (CSA) coordinated by the European Securities and Markets Authority (ESMA). The FIN-FSA sent a survey to six management companies and alternative investment fund managers (AIFMs, hereinafter also firms) concerning the valuation of the assets of funds managed by them. In the thematic review, the FIN-FSA also looked in particular into the valuation of corporate bonds with a low credit rating (hereinafter high yield corporate bonds).

1.2 Objectives of the thematic review

The purpose of the thematic review was to assess how management companies and AIFMs comply with the provisions of the UCITS and AIFM regulatory frameworks pertaining to asset valuation, in particular as regards potentially less liquid asset classes. The objective of the thematic review was to ensure that investments are valued in accordance with regulation in a reliable manner, both in normal and exceptional market conditions[1].

1.3 Summary of key findings of the thematic review

- **Valuation policies[2] were mainly comprehensive**
    - All of the firms reviewed had a valuation policy adopted by the board of directors.
    - One of the firms failed to describe in its valuation policy which party conducts the daily valuation or the tasks, obligations and responsibilities as well as competence and independence of the party.

- **Not all firms described the fund asset valuation methodologies applicable in exceptional market conditions on an asset class-specific basis.**
    - Three firms had objective valuation principles in place, indicating fund asset valuation methodologies for exceptional market conditions on an asset class-specific basis.
    - The other three firms' valuation policy, objective valuation principles or any other guidelines or principles concerning fund valuation did not include asset class-specific procedures for the valuation of the fund's assets in exceptional market conditions.

- **Based on the responses given by the firms, the valuation policies and the valuation methodologies described therein were applied consistently across all funds managed by the firms.**

[1] In this report, exceptional market conditions refer to situations where information from market price sources used in the valuation of fund assets is not reliable or market prices are unavailable.
[2] Applicable regulation uses the concept 'valuation policies and procedures' in reference to a written internal guideline on the process of valuation of the fund's assets. In this report, we call it 'valuation policy'.

    - In addition, two firms described in the valuation policy or another internal guideline on an asset class-specific basis which valuation methodology, including price sources, applies as the primary method and what is the order of priority of other methodologies, if any.
    - One of the firms had defined an order of priority within the systems used in valuation.
    - Three firms indicated the primary valuation method or price source for each asset class, but the order of priority of secondary valuation methods or price sources was not described comprehensively enough in all respects.

- **Each firm's valuation function was independent of portfolio management.**
    - In four of the firms, however, portfolio management could have a supportive or advisory role in the valuation of the fund's illiquid assets or under exceptional market conditions.

- **In each firm, valuation methodologies, including the pricing and market data included in the methodologies as well as their sources, were reviewed on a regular basis.**
    - Furthermore, the valuation function of each firm performed validations of fund asset values on a daily basis.

- **All firms except one provided information to investors on the valuation of fund assets on their website.**
    - In addition, the rules of the funds managed by each of the firms included information, at least on a general level, of the valuation methodologies applicable to the fund in normal market conditions and a reference to methodologies applicable in exceptional market conditions.

- **The internal control functions of four firms had conducted inspections related to the valuation of fund assets in recent years.**
    - In four of the firms, the compliance function had conducted an inspection related to the valuation of fund assets in 2021–2022.
    - In five of the firms, internal audit had conducted or will conduct an audit related to the valuation of fund assets in 2020–2023.

- **As regards the valuation of high yield corporate bonds, all of the firms applied the methodologies described in the valuation policy, and the reliability of price data was verified appropriately.**
    - The valuation of high yield corporate bonds was primarily based on price data available from price data systems.
    - All of the firms ascertained the reliability of price data obtained from third parties by using more than one price sources. In addition, the firms compared the prices used in valuation to the prices of realised trades.

1.4 Overview of regulation

The objective of regulation concerning the valuation of fund assets is to ensure that the value of fund assets is determined consistently and appropriately. The organisation of valuation as a function independent of portfolio management is crucial to secure these objectives and to avoid conflicts of interests.

UCITS' assets are, as a rule, invested in securities and money market instruments traded on regulated marketplaces. The value of fund assets is dictated by the market values of the investments. However, as regards AIFs, the investment universe is broader (including for example real estate and unlisted companies), and therefore it is often impossible to determine the value of their assets based on market values derived from market venues.

Regulation concerning Alternative Investment Fund Managers (AIFM)[3] is more detailed in many respects compared to regulation concerning UCITS management companies[4]. However, the principles governing both regulatory frameworks are consistent.

In the FIN-FSA's view, procedures under the AIFM regulatory framework must also be applied to the valuation of UCITS' assets in order to provide retail investors with at least the same level of protection as AIF investors. In the AIFM regulatory framework, investors, as a rule, are professional investors. ESMA has also presented a similar view in the context of outsourcing arrangements applied by AIFMs.[5]

In addition, IOSCO (The International Organization of Securities Commissions) has issued a guideline on the valuation process for Collective Investment Schemes[6]. In accordance with the first principle, funds should establish comprehensive, documented policies and procedures to govern the valuation of their assets.[7]

1.5 Background information on firms responding to the survey

The six management companies and AIFMs reviewed in the thematic review made up approximately 20% of the number of Finnish fund management companies and authorised AIFMs managing UCITS or non-UCITS investment funds. The assets under management by these six firms accounted for approximately 80% of the total assets of UCITS and non-UCITS investment funds registered in Finland. All of the firms were authorised both as a management company and an alternative investment fund manager.

Three of the firms conducted the daily valuation of fund assets themselves. In two firms, the function performing the daily valuation was outsourced. In both of the firms, the outsourcing was an intra-group arrangement. Portfolio management was outsourced in all but one of the firms. In two of the firms with outsourced portfolio management, portfolio management was outsourced to the same company as the valuation function.

One of the firms did not describe in its responses, valuation policy or other internal documents clearly which party performs the daily valuation. In the FIN-FSA's understanding, this firm had also outsourced the valuation function.

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[3] *AIFM Act (Act on Alternative Investment Fund Managers 162/2014) chapter 9, AIFM Regulation (Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012), Articles 67–74*

[4] *Mutual Funds Act (213/2019) chapter 10, section 4,* and *FIN-FSA regulations and guidelines 3/2011* on the organisation of investment fund activities and code of conduct, section 10.

[5] ESMA Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union (ESMA34-45-344), in particular paragraphs 41 and 42.

[6] *CIS (Collective Investment Scheme) an open end collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments. For the purposes of these Principles, it excludes schemes investing in property/real estate, mortgages or venture capital.*

[7] IOSCO Principles for Valuation of Collective Investment Schemes, FR05/13: IOSCO Principle 1: The Responsible Entity should establish comprehensive, documented policies and procedures to govern the valuation of assets held or employed by a CIS.

Four of the firms had a valuation committee separate from the function performing the daily valuation. Among other things, the committee was responsible for the valuation of fund assets in exceptional market conditions or the provision of advice on valuation-related matters. In one of the firms, the risk management function was responsible for valuation regarding illiquid investments and in exceptional market conditions. In another firm, the function performing the daily valuation initiated the process to determine the valuation method when necessary.

1.6 Background information on UCITS and non-UCITS funds

At the end of July 2022, the net asset value (NAV) of UCITS and non-UCITS investment funds registered in Finland stood at EUR 145 billion. The majority of these funds invested either in equities or fixed-income instruments.

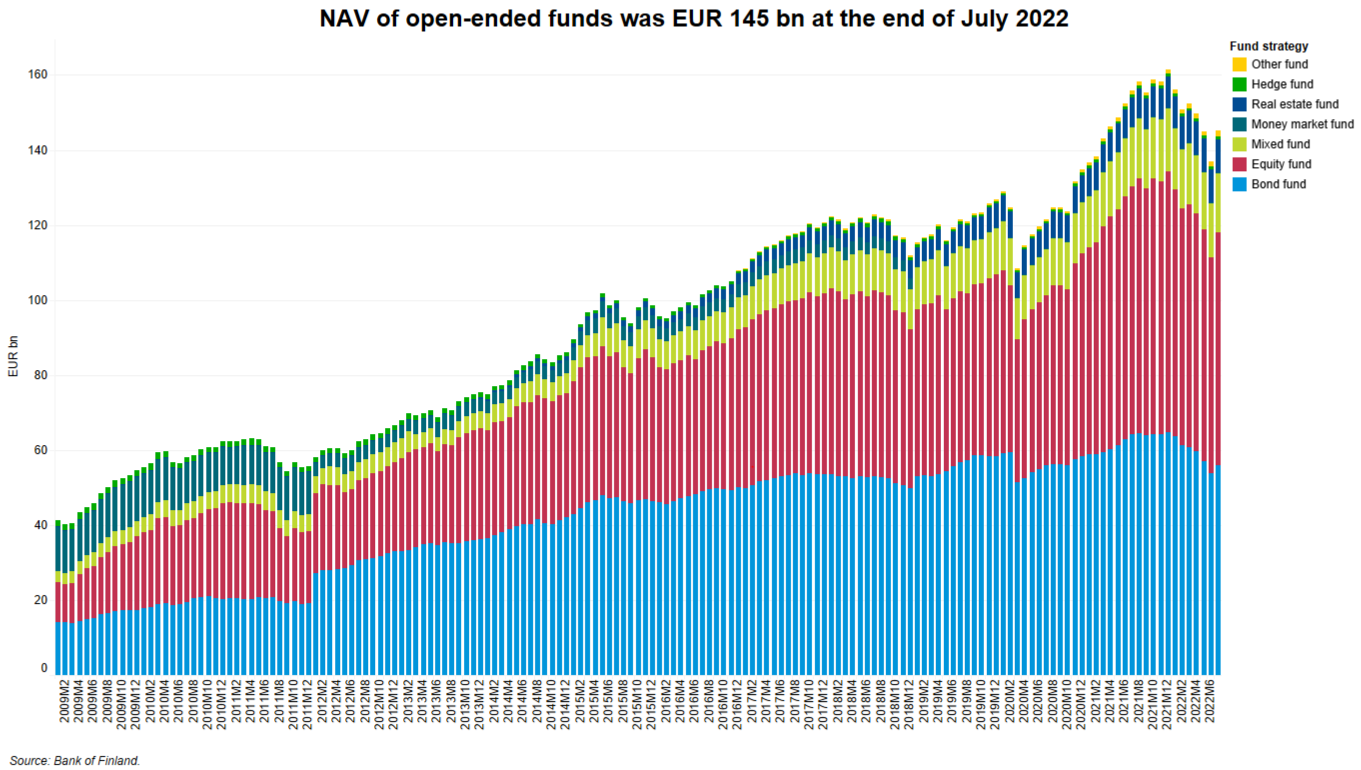
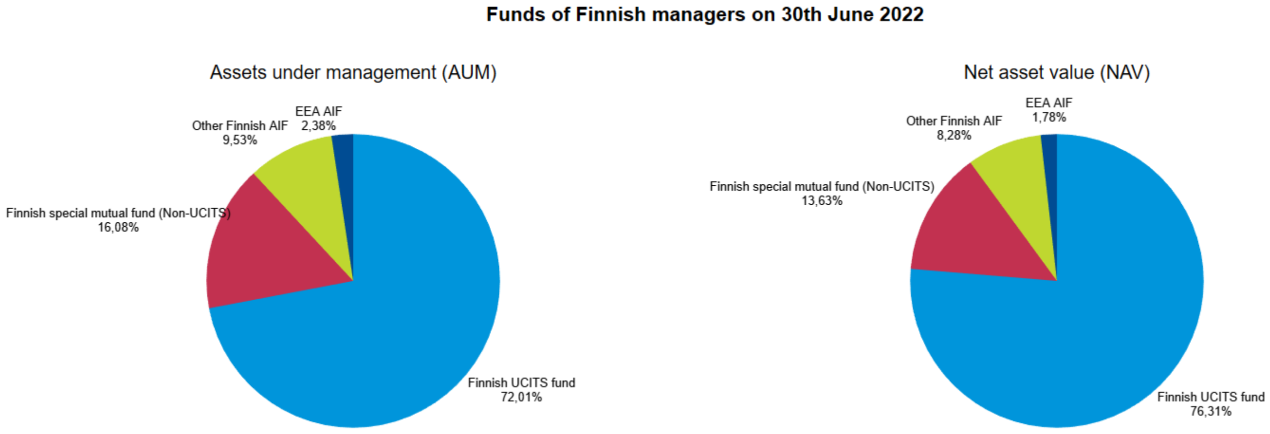


Chart 1. Development of NAV of domestic open-ended funds, July 2022

At the end of June 2022, the number of investment funds registered in Finland totalled 1,046, about half of which (580) were UCITS or non-UCITS investment funds. The assets under management in UCITS and non-UCITS funds amounted to about 90% of the AUM of all investment funds. Most of the AUM was attributable to UCITS funds, which accounted for approximately 70% of the total AUM of all investment funds.



Fund type	AUM	Share of AUM (%)	NAV	Share of NAV (%)	Number of funds
Finnish UCITS fund	118 774 235 267	72,01%	117 636 499 717	76,31%	402
Finnish special mutual fund (Non-UCITS)	26 516 557 194	16,08%	21 013 082 784	13,63%	178
Other Finnish AIF	15 720 766 535	9,53%	12 758 082 221	8,28%	440
EEA AIF	3 922 284 848	2,38%	2 740 281 988	1,78%	21
Grand Total	**164 933 843 844**	**100,00%**	**154 147 946 709**	**100,00%**	**1 041**

Sources: Bank of Finland & FIN-FSA.

Chart 2. Domestic investment fund sector by fund category as at 30 June 2022

2 Valuation policy and other written guidelines

2.1 Criteria

AIFMs shall establish, maintain, implement and review, for each AIF they manage, written policies and procedures that ensure a sound, transparent, comprehensive and appropriately documented valuation process. The valuation policy and procedures shall cover all material aspects of the valuation process and valuation procedures and controls in respect of the relevant AIF.[8]

In accordance with the AIFM Regulation, the valuation policy shall address at least the following:[9]
(a) the competence and independence of personnel who are effectively carrying out the valuation of assets;
(b) the specific investment strategies of the AIF and the assets the AIF might invest in;
(c) the controls over the selection of valuation inputs, sources and methodologies;
(d) the escalation channels for resolving differences in values for assets;
(e) the valuation of any adjustments related to the size and liquidity of positions, or to changes in the market conditions, as appropriate;
(f) the appropriate time for closing the books for valuation purposes;

[8] *AIFM Regulation, Article 67(1)(1).*
[9] *AIFM Regulation, Article 67(2)(2).*

(g) the appropriate frequency for valuing assets;

In addition to the abovementioned, the valuation policy shall also:

- identify the valuation methodologies used for each type of asset in which the AIF may invest[10]
- include inputs, models and the selection criteria for pricing and market data sources[11]
- provide that prices shall be obtained from independent sources whenever possible and appropriate[12]
- set out the obligations, roles and responsibilities of all parties involved in the valuation process[13]

The board of directors of the firm shall review the valuation policy at least annually. The valuation policy shall also be updated before the AIF engages with a new investment strategy or a new type of asset.[14]

The management company shall ensure that fair, correct and transparent pricing models and valuation systems are used for the investment funds under its management, in order to comply with the duty to act in the best interests of the unitholders.[15]

In regulations and guidelines 3/2011, the FIN-FSA has recommended that the board of directors of the management company establishes objective valuation criteria to complement the NAV calculation provisions laid out in the rules of the investment fund, which shall be followed consistently.[16]

2.2 Findings

The FIN-FSA requested the firms to provide policies and guidelines adopted by the board of directors on the valuation of UCITS and non-UCITS investment funds (hereinafter the valuation policy), objective valuation principles and other guidelines or principles pertaining to the valuation of fund assets.

All of the firms reviewed had a valuation policy adopted by the board of directors.

Five firms had a common valuation policy for both UCITS and non-UCITS investment funds. One of these firms had separate valuation policies for liquid and illiquid investments. One of the firms had separate valuation policies for UCITS and non-UCITS investment funds.

There was variation in what the firms understood as objective valuation principles. All of the firms responded that they have objective valuation principles at their disposal, but based on the documents submitted, only three of the firms had such objective valuation principles that indicate the method of fund asset valuation in exceptional market conditions.

The other three firms' valuation policy, objective valuation principles or any other guidelines or principles concerning fund valuation did not include asset class-specific procedures for the valuation of fund assets in exceptional market conditions.

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[10] *AIFM Regulation, Article 67(1)(2).*
[11] *AIFM Regulation, Article 67(1)(3).*
[12] *AIFM Regulation, Article 67(1)(3).*
[13] *AIFM Regulation, Article 67(2)(1).*
[14] *AIFM Regulation, Article 70.*
[15] *FIN-FSA regulations and guidelines 3/2011, section 4.10, paragraph (65).*
[16] *FIN-FSA regulations and guidelines 3/2011, section 10.1.2, paragraph (4).* The contents of the objective valuation principles are not determined in regulation, but according to market practice, objective valuation principles generally refer to guidance for the valuation of the fund's assets under exceptional market conditions.

One of the firms described neither which party conducts the daily valuation of fund assets nor the tasks, obligations, and obligations or its competence and independence of the party.

Five firms responded they review and, if necessary, update the valuation policy on an annual basis. One firm responded that the objective valuation principles, which also cover the valuation of UCITS assets, are reviewed when necessary but at least every three years, while the valuation policy for non-UCITS investment funds is reviewed annually.

2.3 FIN-FSA's view

Regulation concerning Alternative Investment Funds requires that AIFMs prepare an appropriate valuation policy for each AIF. The FIN-FSA requires that management companies also prepare a corresponding valuation policy for UCITS investment funds.

In the FIN-FSA's view, key areas of the valuation process to be addressed in the valuation policy include, in addition to those listed in Article 67(2)(2) of the AIFM Regulation, at least:

- determination of the parties performing valuation both in normal and exceptional market conditions
- order of priority of valuation methods and/or price sources both in normal and exceptional market conditions.

The FIN-FSA considers that it is particularly important that the valuation policy covers any outsourced tasks related to valuation. If outsourced functions have not been documented appropriately, the responsibilities and tasks of different parties may remain unclear. The FIN-FSA points out that regulation and obligations concerning valuation, including requirements for the competence and independence of the personnel performing valuation, also apply to those actually performing the valuation, even if the responsibility for valuation belongs to the firm managing the fund. The obligations, tasks and areas of responsibility of the party performing the valuation, including outsourced tasks, must be described in the valuation policy.

The valuation policy must include, or there must be a separate set of objective valuation principles or comparable internal guidelines describing the valuation methodologies applying to fund assets in exceptional market conditions. The purpose of the objective valuation principles or other comparable internal guidelines is to ensure that a value is determined for fund assets in an appropriate and consistent manner also in circumstances where no market value is available in a price data system or where the price data cannot be relied on. The objective valuation principles or other comparable internal guidelines must include the valuation methods applicable on an asset class-specific basis in exceptional market conditions. Firms must have established guidelines for fund asset valuation in exceptional market conditions regardless of what the guidelines are called and whether they are part of the valuation policy or a separate document.

The FIN-FSA would like to remind that valuation methods which are applied by a firm in exceptional market conditions and described in the objective valuation principles or comparable documents must be such that the firm has adequate expertise, reliable data sources and models as well as appropriate ongoing monitoring and regular inspections.

In the FIN-FSA's view, both the valuation policy and objective valuation principles or comparable guidelines must be reviewed at least on an annual basis and at least whenever changes are made to a fund's investment strategy or the fund invests in new asset classes. In addition, the reviewed documents must be adopted by the firm’s board of directors. The document must indicate the date when it was last reviewed.

3 Consistency of valuation of funds’ assets

3.1 Criteria

The firm shall ensure that the valuation policies and procedures and the designated valuation methodologies are applied consistently.[17]

The valuation procedures and the designated valuation methodologies shall be applied consistently across all AIFs managed by the same AIFM, taking into account the investment strategies and the types of asset held by the AIFs, and, if applicable, the existence of different external valuers.[18]

Management companies shall establish appropriate procedures to ensure the proper and accurate valuation of the assets and liabilities of each investment fund, as consistent with the MFA and/or fund rules or the instruments of incorporation.[19] In regulations and guidelines 3/2011, the FIN-FSA has recommended that the board of directors of the management company establishes objective valuation criteria to complement the NAV calculation provisions laid out in the rules of the investment fund, which shall be followed consistently.[20]

3.2 Findings

Based on the valuation policies of each firm, the policies and the valuation methods described therein are applied consistently across all investment funds managed by the firms.

Two of the firms described in the valuation policy or another internal guideline on an asset class-specific basis which valuation methodology, including price sources, is the primary method and what is the order of priority of other methodologies, if any. One firm’s valuation policy did not clearly indicate which method or price source was the primary one, as the different options were described without an order of priority. However, the order of priority applied by the firm was determined within the systems used in valuation. Three firms indicated the primary valuation method or price source for each asset class in its valuation policy or another internal guideline, but the order of priority of secondary valuation methods or price sources was not described comprehensively enough in all respects.

3.3 FIN-FSA’s view

Firms must ensure that fund assets are valued consistently. Consistent valuation entails that the same valuation method is applied at least to any given asset class in the longer term in accordance with the valuation policy. Furthermore, it may be necessary to determine the order of priority of valuation

[17] *AIFM Regulation, Article 69(1).*
[18] *AIFM Regulation, Article 69(4).*
[19] *FIN-FSA regulations and guidelines 3/2011, section 4.6, paragraph (32).*
[20] *FIN-FSA regulations and guidelines 3/2011, section 10.1.2. paragraph (4).*

methodologies / price sources by instrument within a given asset class, since investments belonging to the same asset class may differ significantly from each other. In addition, the firm must ensure that the same valuation methods and price sources are applied consistently to the same asset classes / investments across different funds regardless of whether the funds are registered in Finland or abroad, however taking the local regulation of the fund's domicile into account.

In the FIN-FSA's opinion, to ensure the consistent valuation of fund assets, the order of priority of valuation methods and/or price sources should be defined clearly for different asset classes / investments and described in the valuation policy or another internal guideline. If the priority order is described in another internal guideline or process, the valuation policy must make reference to the relevant guideline or describe the process. If there are several alternative methodologies or price sources, their order of priority in the context of valuation must be determined and described clearly both for normal and exceptional market conditions. If the priority order has not been determined and described appropriately, one cannot ensure in all circumstances that the valuation of fund assets is performed consistently.

The FIN-FSA finds the determination of the order of priority of valuation methodologies and price sources particularly important in order to be able to perform the valuation of fund assets in a reliable and consistent manner also in circumstances where the use of the primary valuation methodology is infeasible.

Furthermore, in the FIN-FSA's view, the valuation procedures for fund assets in exceptional circumstances must include effective and clear decision-making processes in the event that valuation in exceptional market conditions involves the escalation of the matter for example to the valuation committee, so that the firm is able to perform valuation in an adequately fast and reliable manner, also with respect to investment funds that are open on a daily basis.

4 Independence of the valuation function

4.1 Criteria

The AIFM may perform valuation itself, provided that its valuation function is operatively and otherwise independent of portfolio management. Valuation may be outsourced in accordance with the provisions of chapter 10, section 5.[21]

Where valuation is performed by the AIFM itself, the policies shall include a description of the safeguards for the functionally independent performance of the valuation task in accordance with point (b) of Article 19(4) of Directive 2011/61/EU. Such safeguards shall include measures to prevent or restrain any person from exercising inappropriate influence over the way in which a person carries out valuation activities.[22]

[21] *AIFM Act, chapter 9, section 2.*
[22] *AIFM Regulation, Article 67(4).*

4.2 Findings

Each firm responded that the valuation function is independent of portfolio management and that the firm has appropriate governance arrangements to ensure the operative and hierarchical independence of the valuation function from portfolio management. Three firms ensured the independence of the valuation function so that the valuation function was performed in a different company from portfolio management. Three firms ensured the independence of the valuation function so that it was in a unit separate from portfolio management, and/or the valuation function retrieved the data used in valuation independently from price data systems.

All firms stated they had appropriate governance arrangements in place to ensure that parties inspecting and approving valuation methodologies, policies and guidelines are independent of portfolio management. In all of the firms, the board of directors adopted and reviewed the valuation policies and related valuation methodologies. In two of the firms, the members of the valuation committee responsible for valuation in exceptional market conditions were independent of portfolio management. In two of the firms, the composition of the valuation committee at the individual level was not apparent in the documents provided, so it was not possible to ascertain the role of portfolio management in the valuation committee. One firm without a valuation committee stated that the firm's risk management function is responsible for valuation in exceptional market conditions. Another firm without a valuation committee stated that the valuation function is responsible for valuation in accordance with the objective valuation principles, or in the absence of applicable principles, it initiates the process to determine the valuation methodology. According to the firm's response, valuation in exceptional market conditions is always established by the managing director or deputy managing director.

All firms responded that the remuneration of the valuation function is independent of the performance of the funds. However, according to the internal remuneration guidelines or responses, at least in four firms, the remuneration of the valuation function or members of the valuation committee may be partly based on the result of the group, the firm or the business area.

All firms responded that portfolio management does not contribute in any way to the valuation of the fund's assets. According to the internal guidelines of the firms, however, in four of the firms, portfolio management may have a supportive or advisory role particularly in the valuation of illiquid investments or in the valuation of fund assets in exceptional market conditions. The above could not be ascertained for one of the firms, since the composition of the valuation committee at the individual level was not apparent in the documents provided. Based on the responses and the firms' internal guidelines, the daily valuation of fund assets was conducted independently of portfolio management in all of the firms under review.

4.3 FIN-FSA's view

The firm must organise the valuation function so that it is operatively and otherwise independent of portfolio management.

In firms where executive or senior management also includes personnel responsible for portfolio management, decision making related to valuation must be organised so that any conflicts of interests between portfolio management and the valuation function are identified and managed appropriately.

The performance of investment funds may not have an influence on the remuneration of the valuation function. Despite the outsourcing of the valuation function, the appropriateness of remuneration must be ensured.

The FIN-FSA finds it important that the portfolio manager of a fund may not intervene in or have an influence on the valuation of the fund's assets. The independence of valuation must be preserved throughout the whole valuation process. The final decision concerning valuation must be made by a party entirely independent of portfolio management.

5 Review of valuation methodologies

5.1 Criteria

Valuation policies shall provide for a periodic review of the policies and procedures, including of the valuation methodologies. The review shall be carried out at least annually and before the AIF engages with a new investment strategy or a new type of asset that is not covered by the actual valuation policy.[23]

The valuation policy shall into account among other things) the controls over the selection of valuation inputs, sources and methodologies.[24]

Where a model is used for valuing assets, the valuation procedures and policies should indicate the main features of the model. Before it is used, that model should be subject to a validation process conducted by an internal or external individual who was not involved in the process of building the model. A person should be considered qualified to conduct a validation process in respect of the model used to value assets if he is in possession of adequate competence and experience in the valuation of assets using such models; such person could be an auditor.[25]

The valuation policies and procedures shall ensure that before being used a model is validated by a person with sufficient expertise who has not been involved in the process of building that model. The validation process shall be appropriately documented.[26]

5.2 Findings

In each firm, the valuation methodologies for the investment funds, including the pricing and market data embedded in the methods as well as their sources, were reviewed on a regular basis. In addition, each firm's responses and/or guidelines described daily checks performed by the valuation function on fund assets (for example in circumstances where major price changes are observed, a price is missing, or a price is unchanged).

All but one of the firms applied valuation models (mark-to-model) to certain asset classes. The valuation models were used, among other things, in the valuation of derivatives, money market instruments,

[23] AIFM Regulation, Article 70(1).
[24] AIFM Regulation, Article 67(2)(2).
[25] AIFM Regulation, Preamble (77).
[26] AIFM Regulation, Article 68(2).

unlisted equities, real estate and other illiquid investments. Two firms stated they review the valuation models on a regular basis. The rest of the firms did not review the valuation models regularly. The reasons included, for example, that derivatives were valued using standard models supplied by external service providers and used widely in the markets.

5.3 FIN-FSA's view

Firms must regularly review and inspect their valuation methodologies and their embedded price and market data, also where no specific findings have emerged as a result of the reviews. In the FIN-FSA's view, in connection with the valuation of fund assets, the firms must perform such controls that seek to identify circumstances where there may be an error in the price and market data, such as exceptionally large changes in prices and missing or unchanged prices. The appropriate frequency of assessment of the reliability of price and market data to be conducted in addition to the regular reviews conducted in connection with valuation may depend on such factors as the fund's subscription/redemption frequency, asset class, market conditions and data source. For example, the reliability of price and market data concerning high yield corporate bonds must be reviewed more frequently than usual in the context of a market crisis.

If the firm applies proprietary models in the valuation of assets, the model must be reviewed at least annually, by a party that was not involved in the development of the model. If the firm uses standard models by external service providers, it must assess, at least on an annual basis in connection with the review of the valuation policy, whether the model is still fit for the purpose.

6 Information to be provided to investors on valuation

6.1 Criteria

The rules of the investment fund must specify the more specific grounds for calculating the value of a unit and its subscription and redemption price as well as where when and how the value is published and information on the subscription and redemption prices is made available to the public.[27]

Prior to investment in the fund, the Alternative Investment Fund Manager must make a description of the valuation procedure and price formation procedure used in valuation of the Alternative Investment Fund available to the investor.[28]

The net asset value per unit or share in an AIF shall be reported to its investors at least on an annual basis unless the rules of the AIF concerned provide otherwise. The investors shall be reported on valuations and NAV calculations in accordance with the rules of the AIF.[29]

In recommendations and guidelines 3/2011, the FIN-FSA has recommended that the objective valuation principles are published or otherwise made readily available to investors.[30]

[27] Chapter 8, section 2(1)(9) and (13) of the Mutual Funds Act.
[28] AIFM Act, chapter 12, section 4; Ministry of Finance Decree on the activities of AIFMs (226/2014), section 5(12).
[29] AIFM Act, chapter 9, section 5.
[30] FIN-FSA regulations and guidelines 3/2011, section 10.1.2, paragraph (5).

6.2 Findings

All of the firms responded they provide investors with information on the valuation methods applicable to their UCITS and non-UCITS funds, including the valuation methods for high yield corporate bonds.

Five firms published on their website at least a valuation policy covering the valuation of fund assets in normal market conditions or objective valuation principles for exceptional market conditions. One firm responded the valuation policy is available for investors at request and it has not been published on the website,

The documents on the valuation of fund assets published by three of the firms on their websites enabled investors to be informed of the valuation methodology applicable on an asset class-specific basis in exceptional circumstances. The documents published by two of the firms informed the investor that it was possible to derogate from the valuation methods used in normal market conditions, but the valuation methods applicable in exceptional market conditions were not described to the investors in more detail.

In addition, the rules of the of UCITS and non-UCITS investment funds managed by each of the firms included information, at least on a general level, of the valuation methodologies applicable to the fund in normal market conditions and a reference to methodologies applicable in exceptional market conditions.

According to each firm, investors had been provided information on the governance arrangements concerning the valuation process. However, the documents referred to by one of the firms did not indicate that the valuation function had been outsourced, as only the role of the valuation committee was described in the context of governance arrangements.

Only one firm reported it describes the role of portfolio management in the valuation process in the objective valuation principles. However, as indicated in section 4.2, based on the documentation on valuation, in three other firms, portfolio management may also have a role in the valuation process in exceptional market conditions, even though these firms responded that portfolio management plays no role in the valuation process.

6.3 FIN-FSA's view

The firm must provide information on the valuation of the fund's assets to the investors make it available to them before they invest in the fund. Information on valuation methods applicable on an asset class-specific basis must be provided in the rules of the fund.

In addition, the rules of the fund must also indicate that it is possible to derogate from the reported valuation methodologies in exceptional market conditions. The valuation methods applicable in exceptional market conditions may be described in more detail for example in objective valuation principles made available to investors.

General information on the organisation of and governance arrangements regarding valuation must also be provided or made available to the investors if the valuation function or part thereof has been outsourced or if portfolio management participates in the performance of valuation. The FIN-FSA reminds that, in accordance with chapter 4, section 5(1) of the Ministry of Finance Decree,[31] the extent to which the management company uses agents in its activities must be indicated in the fund prospectus.

7 Management of conflicts of interests

7.1 Criteria

The AIFM shall establish, implement and apply an effective conflicts of interest policy. That policy shall be set out in writing and shall be appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business. Where the AIFM is a member of a group, the policy shall also take into account any circumstances of which the AIFM is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group. The conflicts of interest policy shall determine the following:
a) with reference to the activities carried out by or on behalf of the AIFM, including activities carried out by a delegate, sub-delegate, external valuer or counterparty, identification of the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the AIF or its investors;
b) procedures to be followed and measures to be adopted in order to prevent, manage and monitor such conflicts.[32]

Policies concerning the prevention and management of conflicts of interests must be made in writing and they must take into account the size of the management company, the organisation of activities as well as the nature, scope and diversity of the business. If the supervised entity is part of a group or another amalgamation, the principles must take into account the structure of the group or amalgamation and the activities conducted by its different parts. The policies shall cover the circumstances that may give rise to a conflict of interest entailing a material risk of damage to the interests of the investment fund or one or more clients. The FIN-FSA recommends that the board of directors of the supervised entity adopts the policies governing the prevention and management of conflicts of interest referred to above. The supervised entity should also see that the approved policies are observed and kept up-to-date.[33]

7.2 Findings

All of the firms submitted a policy and operating principles concerning conflicts of interests as required by regulation (hereinafter conflict of interest policy). Four of the firms had prepared their conflict of interests policy at the group level and two firms at the company level.

None of the firms addressed specifically valuation-related conflicts of interests in their conflict of interests policy. However, five firms highlighted methods to manage conflicts of interests in their responses. These included the operative segregation of the valuation function from portfolio management, independence of the remuneration of the valuation function from fund performance, regular training given to

[31] Decree of the Ministry of Finance on statements to be attached to the application for authorisation of a management company and depositary, and on remuneration schemes, fund prospectus and financial instruments referred to in chapter 13 of the Mutual Funds Act as well as the scope of information to be made available by a UCITS (257/2019)
[32] AIFM Regulation, Article 31.
[33] FIN-FSA regulations and guidelines 3/2011, section 4.9.2.

personnel on the identification of conflicts of interests, restriction and monitoring of personal trading by personnel working in the valuation function, and the application of the four-eyes principle in manual valuations. In addition, two firms responded that potential or realised conflicts of interests had been identified in the context of valuation.

Two firms whose valuation function was outsourced specifically considered conflicts of interests related to outsourcing or between different group companies in their conflict of interests policy.

One firm with an outsourced valuation function referred in its response to the segregation of the valuation committee from portfolio management as a way of managing conflicts of interests, but did not address in its response or conflict of interests policy any potential conflicts of interests related to the company performing the daily valuation.

7.3 FIN-FSA's view

The FIN-FSA reviewed the conflict of interests policy and responses only from the perspective of fund asset valuation. In accordance with section 4.2, based on the responses, all firms had appropriately segregated portfolio management from the valuation function. Hence, as a rule, the risk of valuation-related conflicts of interests in these firms is lower than in firms where these functions have not been segregated, portfolio management has some role in the execution of valuation or governance arrangements are deficient in some other respect.

In firms which have outsourced the valuation function or some other function, the conflict of interests policy and operating principles must also cover conflicts of interests related to the outsourced function.

Even if the conflict of interests policy is prepared at a general level and it does not address the valuation function, the firms must nevertheless always assess whether valuation involves conflicts of interests. If conflicts of interests are identified, they must be managed appropriately, and both the identified conflicts of interests and their management methods must be documented.

In the FIN-FSA's view, firms that have outsourced both the valuation function and portfolio management must pay particular attention in the management of conflicts of interests to valuation-related conflicts of interests, since the daily monitoring of neither function is organised within the company in this case. This requires particular attention when both functions are outsourced to the same party.

8 Prevention, identification and compensation of NAV calculation errors and valuation errors

8.1 Criteria

A management company shall correct any material error in the published value of the fund unit without delay. Any error concerning the published value of the fund unit must be reported immediately to the FIN-FSA, which shall determine whether the error is material.[34]

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[34] *Chapter 15, section 9(3) of the Mutual Funds Act.*

An AIFM shall ensure that remedial procedures are in place in the event of an incorrect calculation of the net asset value.[35]

In order that the management company could correct any material errors in the published value of the fund share, the FIN-FSA recommends that it prepares a written guideline on the policies and procedures aimed at preventing the occurrence of NAV calculation errors, ensure that NAV calculation errors are detected, and determine policies and the decision-making procedure to correct NAV calculation errors and compensate them to the investors.[36]

The FIN-FSA recommends that the management company compensates at least material NAV calculation errors. The FIN-FSA recommends that the management company compensates losses incurred by the investment fund and unitholders who made subscriptions or redemptions in the fund so that the position of the investment fund and unitholders is at least restored to the same level (or better) as if the error had not occurred at all.

8.2 Findings

According to the responses, all firms had established procedures for the early identification and prevention of NAV calculation errors and valuation errors.

In four of the firms, these procedures were apparent in the written operating principles. According to the firms, NAV calculation errors are identified and prevented among other things by comparing changes in a fund's NAV to the benchmark index, and by performing various reconciliations of transactions and assets on a regular basis.

In addition, the firms referred in their responses to regular checks concerning the valuations of investments, which were also discussed in section 5.

All firms submitted an internal guideline describing the escalation procedures for the event of a NAV calculation error and how NAV calculation errors are compensated to the clients. All firms compensated at least material NAV calculation errors.

8.3 FIN-FSA's view

The FIN-FSA reminds that in circumstances where NAV calculation errors or valuation errors are identified, their underlying reasons must be examined carefully. If NAV calculation errors are recurrent, particular attention must be paid to preventing them.

Valuation checks performed at the level of an individual investment also prevent the occurrence of NAV calculation errors.

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[35] AIFM Regulation, Article 72(3).
[36] FIN-FSA regulations and guidelines 3/2011, section 10.2.1, paragraph (10).

9 Consideration of liquidity stress tests in valuation

9.1. Criteria

The management company shall conduct appropriate periodic stress tests and scenario analyses on each investment fund under its management to address risks arising from potential changes in market conditions that might adversely impact the investment fund. The management company shall conduct appropriate stress tests which enable assessment of the liquidity risk of the investment fund under exceptional circumstances.[37]

To ensure liquidity, the AIFM shall regularly perform stress tests that evaluate the liquidity risk.[38]

AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each AIF under their management.[39]

9.2 Findings

All of the firms responded that they do not directly consider the results of liquidity stress tests in valuation. However, one firm responded that it reviews the reliability of the valuation process if liquidity-related challenges arise in liquidity stress testing.

All but one of the firms responded they have reviewed their liquidity stress testing policies, models or guidelines as a result of events associated with the COVID crisis[40] for example by adjusting the assumptions or scenarios of the stress tests so as to better account for the market situation prevailing at the time of the COVID crisis.

9.3 FIN-FSA's view

In accordance with Article 48(2)(d) of the AIFM Regulation, liquidity stress tests shall account for valuation sensitivities under stressed conditions. The valuation of a given asset may vary significantly depending on market conditions. Therefore it is crucial to consider this sensitivity in assessing the liquidity of the asset and the whole fund. If the value of an asset is expected to decline steeply in exceptional market conditions, this may have a material impact on the liquidity of the asset.

The relationship between valuation and liquidity works in the other direction, too. In particular, the value of assets with low liquidity may decline steeply in exceptional market conditions.

The FIN-FSA considers that the expected liquidity of an asset in both normal and exceptional market conditions must be accounted for in valuation. If it is identified based on the stress tests that an investment of the fund is exposed to particular risk of low liquidity, it may also be necessary to review whether this risk is adequately considered in the valuation process and whether adjustments should be made to the process.

[37] FIN-FSA regulations and guidelines 3/2011, section 8.2, paragraph (11)(c) and paragraph (8).
[38] AIFM Act, chapter 8, section 6(2.
[39] AIFM Regulation, Article 48(2).
[40] The COVID crisis refers to the period from March 2022 to June 2020.

10 Control functions for valuation

10.1 Criteria

Risk Management

An AIFM shall have adequate internal monitoring and risk management arrangements in relation to its operations. The appropriateness of the arrangement shall be reviewed and, if necessary, updated at least annually. Risk management shall be organised so that it is possible to identify, measure, manage and monitor all material risks related to the investment policies of each AIF and to which each AIF is subjected or may be subjected.[41]

Risk management systems shall be understood as systems comprised of relevant elements of the organisational structure of the AIFM, with a central role for a permanent risk management function, policies and procedures related to the management of risk relevant to each AIF's investment strategy, and arrangements, processes and techniques related to risk measurement and management employed by the AIFM in relation to each AIF it manages.[42]

The management company must maintain a permanent risk control function.[43]

Compliance function

AIFMs shall establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the AIFM to comply with its obligations under the AIFM Directive, and the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise their powers effectively under that Directive.[44]

The management company shall have adequate policies and procedures designed to detect any risk of failure by the management company to comply with its obligations under the Mutual Funds Act. The management company shall implement and maintain these policies and procedures, and they shall have appropriate measures and procedures in place to minimise such risks. Management companies shall take into account the nature, scale and complexity of their business, and the nature and range of services and activities undertaken in the course of that business.[45]

Internal audit

AIFMs shall, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM.[46]

[41] AIFM Act, chapter 8, section 1.
[42] AIFM Regulation, Article 38(1).
[43] FIN-FSA regulations and guidelines 3/2011, section 7.3.
[44] AIFM Regulation, Article 61(1).
[45] FIN-FSA regulations and guidelines 3/2011, section 7.2.
[46] AIFM Regulation, Article 62(1).

The management company, where appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of collective portfolio management activities undertaken in the course of that business, to establish and maintain an internal audit function which is separate and independent from the other functions and activities of the management company.[47]

Depositary

The depositary shall ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.[48]

A depositary shall be deemed to comply with the requirements set out in point (b) of Article 22(3) of Directive 2009/65/EC where it puts in place procedures to:

a) verify on an ongoing basis that appropriate and consistent procedures are established and applied for the valuation of the assets of the UCITS in compliance with the applicable national law as laid down in Article 85 of Directive 2009/65/EC and with the UCITS rules or instruments of incorporation;
b) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.[49]

Auditor

At least one certified public accountant (KHT auditor) or an audit firm in which the principal auditor is a certified public accountant shall at least annually audit the correctness of the NAV calculation of the fund unit and check the value of the last NAV calculation date of the calendar year on which the values of the UCITS have been calculated.[50]

10.2 Findings

Three firms responded their risk management function performs regular validations related to valuation, such as daily or monthly validations of source data or prices.

In addition, according to the responses, the risk management function participated within the firms among other things in the valuation of illiquid assets, reporting of NAV calculation errors and monitoring of the outsourced valuation function.

In four of the firms, the compliance function had conducted an inspection related to the valuation of fund assets in 2021–2022.

In five of the firms, internal audit had conducted or will conduct an audit related to the valuation of fund assets in 2020–2023. In one of the firms, internal audit had made negative findings related to valuation, which had been subsequently corrected appropriately.

[47] FIN-FSA regulations and guidelines 3/2011, section 7.4.
[48] AIFM Regulation, Article 94(1)(b).
[49] UCITS Regulation (Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries), Article 5(1)(a) and (b).
[50] Mutual Funds Act, chapter 7, section 3(1).

Five firms responded the depositary had performed, in addition to the regular review of fund values, separate inspections related to valuations or the valuation process.

All firms responded the auditor had performed, in addition to the audit of the correctness of fund NAV calculation, separate audits related to valuations or the valuation process.

10.3 FIN-FSA's view

The FIN-FSA considers it good practice that a party independent of the party performing the daily valuation, such as the risk management function, ensures the consistency of valuation for example by regularly inspecting the source data or prices used in valuation. This is particularly useful where the valuation function is outsourced or the valuation of an asset involves uncertainty for example due to exceptional market conditions or where a different valuation method than usual has been employed.

The participation of risk management in the valuation of illiquid assets or valuation in exceptional market conditions may effectively support the performance of valuation in these special situations.

The firm's internal control functions (compliance and internal audit) should review fund valuation at certain intervals.

11 Valuation practices for high yield corporate bonds

11.1 Criteria

The criteria presented in the previous sections also apply to the valuation of high yield corporate bonds. In addition, the FIN-FSA considers that particular attention should be paid to the following criteria in context of valuation of high yield corporate bonds.

The valuation policies and procedures shall set out a review process for the individual values of assets, where a material risk of an inappropriate valuation exists, such as in the following cases:

a) the valuation is based on prices only available from a single counterparty or broker source;
b) the valuation is based on illiquid exchange prices;[51]

The valuation policies and procedures shall outline how a change to the valuation policy, including a methodology, may be effected and in what circumstances this would be appropriate. Recommendations for changes to the policies and procedures shall be made to the senior management, which shall review and approve any changes. [52]

The valuation policies and procedures shall describe the review process including sufficient and appropriate checks and controls on the reasonableness of individual values. Reasonableness shall be

[51] *AIFM Regulation, Article 71(2).*
[52] *AIFM Regulation, Article 70(2).*

assessed in terms of the existence of an appropriate degree of objectivity. Such checks and controls shall include at least:
a) verifying values by a comparison amongst counterparty-sourced pricings and over time;
b) validating values by comparison of realised prices with recent carrying values;
c) considering the reputation, consistency and quality of the valuation source;
d) a comparison with values generated by a third party;
e) an examination and documentation of exemptions;
f) highlighting and researching any differences that appear unusual or vary by valuation benchmark established for the type of asset;
g) testing for stale prices and implied parameters;
h) a comparison with the prices of any related assets or their hedges;
i) a review of the inputs used in model-based pricing, in particular of those to which the model's price exhibits significant sensitivity.[53]

11.2 Findings

All of the firms responded that the valuation of high yield corporate bonds takes place in accordance with the valuation policy, similarly to other corporate bonds, both in normal and exceptional market conditions. All firms applied primarily price data from price data systems in the valuation of high yield corporate bonds. In addition, one firm was going to adopt a more detailed order of priority of valuation methods particularly for high yield corporate bonds as part of the valuation policy. The firm had applied this order of priority already at least in the context of the COVID crisis.

The firms responded they conduct the same regular reviews on high yield corporate bonds as on other assets, as discussed also in section 5. The firms ensured the reliability of price data obtained from third parties by using more than one price sources to check the prices of high yield corporate bonds. In addition, the firms compared the prices used in valuation to the prices of realised trades.

The firms responded they ensure the reliability of valuation in exceptional market conditions for example by escalating the valuation of individual high yield corporate bonds to the valuation committee or by adopting special valuation methods for exceptional market conditions.

Four firms did not apply special valuation models (mark-to-model) in the valuation of high yield corporate bonds. Two firms stated they mark to model in exceptional market conditions.

Observations about the valuation of high yield corporate bonds during the COVID crisis

All but one of the firms had experienced challenges in the valuation of high yield corporate bonds during the COVID crisis. According to the firms, a particular challenge was that prices available from price data sources did not correspond to the actual market price of high yield corporate bonds. Therefore, the firms had made extra validations of prices. All firms had identified risks related to the valuation of high yield corporate bonds (such as the unreliability of prices and the endangerment of the fair treatment of unitholders). However, none of the firms had detected errors in the valuation of high yield corporate bonds. Two firms had been forced to halt subscriptions and redemptions in certain funds on a temporary basis, and one firm had adopted swing pricing in the NAV calculation of a fund. Four firms had activated escalation procedures concerning fund asset valuation.

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[53] *AIFM Regulation, Article 71(3).*

<u>Findings on the valuation of a specific high yield corporate bond</u>

The firms were requested to describe the valuation process and related validations concerning a predetermined high yield corporate bond at a certain point in time. All firms had conducted the valuation of the high yield corporate bond concerned as well as related validations in accordance with their valuation policy. However, there was variation in the outcome of the valuation across the firms, since some of them applied the bid price and while some applied the mid price (average between the bid and ask quotes) obtained from a price source.

11.3 FIN-FSA’s view

The FIN-FSA considers that the same basic principles applying to other asset classes can, as a rule, be also applied to the valuation of high yield corporate bonds, and it is in fact recommended to ensure consistent valuation. However, the FIN-FSA considers that high yield corporate bonds have special characteristics that must be taken into consideration in their valuation. As could be seen during the COVID crisis, the market price and liquidity of high yield corporate bonds may be more sensitive to negative changes in exceptional market conditions. Furthermore, high yield corporate bonds are not necessarily traded on a regulated market or other trading venue, real price data based on realised transactions may not be available, and prices quoted by various counterparties are indicative and not necessarily attainable in particular in exceptional market conditions.

These characteristics of high yield corporate bonds can be taken into account in valuation for example through the following procedures:

- avoidance of the use only a single counterparty as a price source; instead, for example a combination price could be used or at least the price source could be compared to one or several other price sources:
- documentation of the order of priority of price sources used to ensure consistent valuation (described in more detail in section 3)
- identification of situations where it is possible to derogate from the primary valuation method and who decides, reviews and approves potential derogations concerning valuation methods
- ensuring the reliability and validity of price sources through regular and appropriate reviews. In the context of validations concerning high yield corporate bonds, consideration must be paid at least to the following matters specified in Article 71(3) of the AIFM Regulation, which are in the FIN-FSA’s view particularly relevant from the perspective of high yield corporate bonds. The frequency of the validations may vary, and there may also be variation in whether they are conducted in normal or exceptional market conditions, or both.
    - verifying values by a comparison amongst counterparty-sourced pricings and over time;
    - validating values by comparison of realised prices with recent carrying values;
    - considering the reputation, consistency and quality of the valuation source;
    - an examination and documentation of exemptions;
    - testing for stale prices and implied parameters;
    - a review of the inputs used in model-based pricing, in particular of those to which the model’s price exhibits significant sensitivity.

In the FIN-FSA's view it may also be necessary to run these validations on other corporate bonds.

The methods used in the valuation of high yield corporate bonds and also other illiquid asset classes shall be documented on an asset class-specific basis in the valuation policy or other internal guideline. If derogations from the primary valuation methods are made, the reasons shall be documented.

Due to the special characteristics of high yield corporate bonds, particularly in exceptional market conditions, attention must be paid to the assessment of the reliability of price sources and validations of daily price data, which may call for a more in-depth and extensive assessment than in normal circumstances.

The firms should be aware of the impacts on valuation of the decision, whether corporate bonds held by a fund are valued based on their bid, ask or mid price. Especially in exceptional market conditions, the spread between the bid and ask price may widen considerably. The practical impacts also depend on whether the fund is facing more subscription or redemption orders. Particularly in exceptional market conditions, the volume of redemptions may increase considerably in comparison to normal market conditions. One possible way to manage the widening of spreads is the adoption of swing pricing (flexible pricing method). However, before this method is adopted, one must ensure its suitability for the fund concerned, adequate personnel, IT and other resources, and that the practical impacts of the method are understood by the investors.