

ASSET MANAGEMENT AND INVESTORS COUNCIL

Mohamed Ben Salem
IOSCO General Secretariat
International Organisation of Securities Commission (IOSCO)
Calle Oquendo 12
28006 Madrid
SPAIN

November 4, 2010

Sent by email

Dear Mr Ben Salem,

Consultation Report on Intermediary Internal Controls Associated with Price Verification of Structured Finance Products and Regulatory Approaches to Liquidity Risk Management.

The ICMA Asset Management and Investors Council (“AMIC” or “the Council”) was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC’s focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the IOSCO Consultation Report on Intermediary Internal Controls Associated with Price Verification of Structured Finance Products and Regulatory Approaches to Liquidity Risk Management. The AMIC has been very interested and engaged in the issue of valuation of assets and in this response makes some recommendations as regards the establishment and evolution of valuation policies and procedures. The Council has focused on valuation governance arrangements for funds, particularly in the case of valuation of complex products such as ABS and structured products. Council members were supported by KPMG in this work.

General Comments

The market turmoil has led market participants to demand greater transparency and enhanced governance, specifically over the valuation and reporting of illiquid investments.

Valuation has always been key to the investment management business. Inaccurate valuation can undermine effective asset allocation for investors, as well as risk management and performance reporting for managers. It can lead to an erroneous net asset value being used as a basis for investor activities, tax reporting, secondary market transactions and fee calculations.

Over the past few years, the overall dynamics of the market crisis and specific legal issues involving inaccurate valuations have pushed investors to demand greater transparency. As the value of stocks and other publicly traded instruments has declined somewhat more than illiquid investments, some investors have found their allocation to alternative investments transformed from a relatively small part of their overall portfolios into a much larger proportion. This shift has prompted them to want a more thorough understanding of valuations of illiquid investments.

The trend toward increased investor scrutiny of valuation, combined with modifications in financial reporting standards (for example, fair value accounting requirements per FAS 157, now known as ASC Topic 820) and the passage of the US Dodd-Frank legislation requiring all but the smallest alternative asset managers to register with the Securities and Exchange Commission (SEC), will mean significant changes for the ways in which fund managers carry out and support their valuations. These changes will have an impact on all facets of alternative asset managers' business models, from fundraising to back-office infrastructure. In this regard the Alternative Investment Fund Managers Directive in effect calls for a clear separation between the deal-making/front-office and valuations functions.

While market participants—investors, auditors, lawmakers and regulators—are not all likely to have identical motivations for focusing on the valuation of illiquid investments, they all look favourably upon approaches to valuation that make processes more transparent, consistent and better documented, and that provide a clear governance structure around those processes.

A Fund should have formalised Valuation Governance Arrangements.

This would include a formal Valuation Policy detailing Valuation practices, procedures and controls. Valuations could be out-sourced to a third party service or there may be a Valuation/Independent Price Verification (IPV) unit internal to the fund or a combination of the two. If Valuations are outsourced to a third party, the Board of the asset management institution is responsible for making sure the policy is followed. In all cases, the Board is ultimately responsible for ensuring the accuracy of Valuations.

The policy should be reviewed at least annually or where there is a material change of business. The Valuation Policy should cover:

1. Independence

Parties controlling the Valuation and NAV determination process should be independent from parties involved in the investment process. Roles and Responsibilities of each party in the Valuation process should be clear. Advice should also be given to senior management, and where relevant, Boards, on all valuation issues especially requests to changes valuation policies. Adequate reporting should be provided to enable the Board and senior management to have

effective oversight of valuation process and also for client disclosures.

2. Investor Disclosure

The fund manager should disclose key assumptions used to value portfolio investments. Any investments in complex and/ or illiquid products should be disclosed due to the associated "Valuation uncertainty" (often referred to as "model risk"). Funds should ensure that the liquidity of such instruments, as well as the risks and rewards, are fully understood by clients. Material changes to valuation policies and/ or methodologies should also be disclosed, and the valuation impact of such changes.

3. Due diligence

Market prices/ Broker quotes should be obtained for all products (where possible) on the portfolio/fund valuation date. For complex or illiquid products, if it is not possible to get a quote for the exact product, quotes for similar products should be obtained as far as possible. Long positions should be marked to Bid price, and Short positions should be market to the offer price. In the event of no quote being obtained, it is recognised that Valuation models would be used.

4. GIPS Valuation Requirements

GIPS are industry developed standards which have now been adopted in 32 countries around the world and which set minimum requirements for the calculation and presentation of historic investment performance to prospective clients. For periods beginning on or after 1 January 2011, Portfolios must be valued in accordance with the definition of fair value and the GIPS valuation principles. Firms must comply with relevant laws or regulations relating to valuation. Where permissible, firms should follow the GIPS Valuation Recommendations and incorporate the following Valuation Hierarchy into their policies for determining Fair value (see attached GIPS Valuations Principles). If laws or regulations require a different treatment then this should be disclosed alongside the historic performance presentation.

- a. Investments must be valued using objective, observable, unadjusted quoted market prices for identical instruments in active markets on the measurement date, if available. If not available, then investments should be valued using:
- b. Objective, observable quoted market prices for similar investments in active markets. If not available or appropriate, then investments should be valued using :
- c. Quoted prices for identical or similar investments in markets that are not active (markets in which there are few transactions for the investment, the prices are not current, or price quotations vary substantially over time and/or between market makers). If not available or appropriate, then investments should be valued based on:
- d. Market-based inputs, other than quoted prices, those are observable for the investment. If not available or appropriate, then investments should be valued based on:

- e. Subjective unobservable inputs for the investment where markets are not active at the measurement date. Unobservable inputs should only be used to measure Fair value to the extent that observable inputs and prices are not available or appropriate. Unobservable inputs reflect the firm's own assumptions and the assumptions that market participants would use in pricing the investment and should be developed based on the best information available under the circumstances.

5. Model Controls and Usage:

Note: Simple liquid products will be valued directly from market data e.g. large cap equities. Other products are marked to market via a Valuation model which uses market data as an input. In reality, "Fair value" is more complex than this. The rest of this section concerns assets which are valued using a model.

- i. All models should be documented, validated, reviewed on a regular basis by an independent party. Changes to models should be reviewed and signed off by the independent party. All model inputs and source of data should be specified and documented. The weaknesses and limits of use (e.g. market conditions, high volatility etc) should be documented.
- ii. Valuation Models should be designed, documented, reviewed and validated by a team independent of parties involved in the investment process. There should be a formal process for change control. All changes to models should be documented, reviewed, validated and signed off by the independent party. All model inputs and source of data should be specified. The weaknesses and limits of use (e.g. market conditions, high volatility etc) should be documented.
- iii. All portfolio assets should have a designated model for Valuation purposes. All models should have designated data inputs from designated sources. Inputs should be observable where possible. Examples of observable inputs are stock price or interest rates which can be readily sourced from standard market data (e.g. Bloomberg, Reuters). Unobservable inputs should only be used where observable price inputs are not available or inappropriate. Correlation and volatilities change dramatically over time and one's possibility of observing is highly problematic. Ideally, unobservable parameters and related models and products should be reviewed by senior management on a regular basis.
- iv. The effect of the bid-offer spread should be taken into account when marking to market positions (see point 3).

6. Consistency in Valuations for Fund of Funds

Fund of Funds should ensure that all underlying investments are made in funds which have Valuation policies which represent Best Practice.

7. Illiquid Assets

Real Estate, infrastructure and Private equity investments should be periodically valued by suitably qualified third parties. Structured products should only be

considered “investable” if the collateral and waterfall structure is transparent and clearly understood.

8. Compliance

All relevant legal and regulatory requirements should be followed.

9. Linkage to Risk Management

Funds should have a clear Mandate and Risk Management policy with appropriate risk limits including concentration and liquidity limits. There is an operational cost of investing in complex products. Good Risk Management discipline should result in a Manager only investing in products where risks and rewards are clearly identifiable.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Robert Parker". The signature is written in a cursive style with a long horizontal stroke at the end.

Robert Parker
AMIC Chairman

Encl. GIPS Valuation Principles