



European Securities and Markets Authority
103 Rue de Grenelle
75007
Paris

By email

13 September 2011

Dear Sirs

**Implementing Measures on the Alternative Investment Fund Managers Directive -
IV.VIII. Possible Implementing Measures on Valuation**

The International Valuation Standards Council (IVSC) welcomes the opportunity to comment on ESMA's Consultation Paper issued on 13 July 2011 containing draft technical advice to the European Commission on possible implementing measures for the Alternative Investment Fund Managers Directive ("the AIFMD").

About the IVSC

The IVSC is an independent, not-for-profit, private sector organisation formed with the objective of strengthening the worldwide valuation profession in the public interest. It achieves this objective by:

- Developing high quality international standards and supporting their adoption and use;
- Facilitating collaboration and cooperation among its member organisations;
- Collaborating and cooperating with other international organisations; and
- Serving as the international voice for the valuation profession

The membership of IVSC comprises nearly sixty professional valuation bodies from fifty countries. The IVSC also receives financial support from a number of the global valuation firms. Members of our member bodies and supporting firms undertake valuations of all types of assets and liabilities for many purposes, and will include all of the main providers of external valuation services to AIFMs. Within the timescale allowed for responding to this Consultation Paper the IVSC has not had an opportunity to undertake its own formal consultation with its membership. The comments in this letter are therefore based on the experience of the Board members and staff of the IVSC and our experience in developing and setting valuation standards for different types of asset for different purposes.

The IVSC Standards Board has recently completed a three year project to review and update the International Valuation Standards (IVS), culminating in the publication of twelve completely revised standards in July 2011. These include a Framework containing generally accepted valuation concepts and principles, standards for the conduct and reporting of valuations generally and specific standards for the valuation of each major asset class, eg business interests, real property and financial instruments.

Our Comments on Consultation Paper

In this letter we comment specifically on the proposals in the Consultation Paper concerning valuation in section IV VIII. We have previously provided comments on the invitation originally made to CESR by the EU Commission in a letter dated 13 January 2011.

We note that ESMA is requested to advise the Commission on the following issues concerned with the valuation of assets within an AIF:

- criteria for the proper valuation of assets and the calculation of the net asset value,
- the type of specific professional guarantees an external valuer should be required to provide and
- the frequency of valuation carried out by open-ended funds.

We further note that there are no questions specifically related to the proposed implementing measures on valuation. We have therefore commented on the Introduction on pages 113 and 114 and proposals set out in Boxes 55 – 62 of the Consultation Paper.

The comments all reflect the IVSC's commitment to independent and professionally based valuation, and that in the case of valuations of assets held in an AIF the valuation procedures and methods adopted should be transparent to investors and regulators alike.

Comments on Introduction (page 113 -114)

Paragraph 4 Reference is made in the opening sentence to “different existing valuation standards”. It appears from the remainder of the paragraph, the reference to the IOSCO 1999 Valuation Paper and the contents of Box 55 that the word “standards” is being used to refer to regulations or protocols on what should be valued, when valuations should be undertaken, and who should carry them out. This usage of the word risks confusion with the International Valuation Standards (IVS). The IVS are concerned with how the actual valuation assignment should be carried out. The IVS are not concerned with identifying what should be valued, when it should be valued or who should undertake the valuation, apart from stipulating that appropriate controls and procedures should be in place to ensure independence and objectivity in the valuation process.

To avoid confusion between the proposed implementing measures on valuation under the AIFMD and valuation standards, we recommend that the word “standards” is avoided in this context. Policies and procedures (as used in Box 55) is a more appropriate term.

Paragraph 7 The suggestion is made that the valuation of assets that are not financial instruments has to take place at least once a year. We are concerned that this could lead to annual valuations being accepted as the norm. Experience has shown that asset values can change rapidly, and it is in the public interest that investors are informed of these changes as quickly as possible.

We recommend that an AFIM should be required to revalue any class of asset more frequently than once a year where there is a reasonable expectation that there has been a significant change in value since the last valuation disclosed to investors.

Box 55 (1) We are again concerned at potential confusion between valuation policies and procedures and valuation “methodologies”. The terms appear to be used interchangeably in this paragraph. However, a valuation method, or the methodology to consider different methods, is normally associated with the technique or techniques used by the valuer to estimate value; in other words it is part of the valuation process, not a description of the policy used to determine when a valuation should be undertaken.

We recommend that the words “method” or “methodology” are not used to describe valuation policies and procedures that an AIFM should have in place.

Box 55 (2) The potential confusion caused by the imprecise use of language is exemplified in this paragraph. The statement that the “valuation methodology in respect of the specific type of asset has to be identified prior to investment in that type of asset” may be intended to require the AIFM to have policies and procedures for the valuation of that type of asset in place before investing. That would appear to be perfectly sound and represent good practice. However, to any reader familiar with valuation terms, the statement seems to suggest that the AIFM should be determining how future valuations of that type of asset should be calculated before investing. This interpretation seems to be reinforced by the explanatory note (paragraph 9) which mentions some specific valuation methods.

Such a requirement would be wholly inappropriate as it conflicts with good valuation practice. It is a fundamental principle of IVS that valuations should be undertaken using methods that are established and accepted by investors and other participants in the relevant market for the assets held in the fund.¹ Because markets are dynamic these methods can and do change over time. The relevant method is the one that is appropriate on the date on which the valuation applies, not one predetermined in a valuation policy document.

See recommendation for 55 (1). If, however, it is intended to propose that an AIFM should include directions on the methods that should be used to value different assets in their valuation policy we must recommend that this proposal be removed from the final paper as it conflicts with established best practice and would be detrimental to investors. IVS 103 *Reporting* requires the valuation approach and key inputs used to be disclosed in the valuation report, but these are not determined in advance of the start of the valuation process to which the report relates.

¹ IVS Framework paras 72-73

Box 55 (4&5) For your information, IVS 101 *Scope of Work* requires there to be an exchange of information between the client and the valuer to ensure that all necessary information required for the purpose of performing the valuation task are provided, and it includes a list of matters that should be considered as part of that process. With regard to paragraph 5, the proposed new IVSC *Code of Ethical Principles for Professional Valuers* identifies threats to objectivity in a valuation context and safeguards that may be appropriate. Further, in recognition of the preponderance of internal valuations of complex financial instruments, IVS 250 *Financial Instruments* includes additional guidance on the criteria for an appropriate “control environment” to protect the objectivity of valuations.²

In order to achieve consistency in the way that national regulators apply the implementing measures proposed for valuation, we recommend that valuations undertaken of assets (and liabilities) in an AIF be undertaken in accordance with the International Valuation Standards. The IVS contain specific requirements and guidance around the valuation process itself that are aimed at ensuring objectivity, consistency and transparency with the objective of increasing the confidence of investors and other users in valuations on which they rely.

Box 56 While we agree that it is a good practice for any valuation model used to be a) validated and b) disclosed, for the same reasons as stated in our comments on Box 55 (2) the AIFM should not be required to prescribe the model to be used in the valuation policies and procedures. The theories on which models are based evolve, and market acceptance of different models changes. We also add a caution that while we support the principle of disclosing the model in the valuation report, there are practical issues caused by the extreme mathematical complexity of some models used for valuing complex instruments. Achieving a level of disclosure that would be meaningful and helpful for even professional investors could be a challenge. ESMA may also wish to note that IVSC is just commencing a project on Valuation Methods for OTC Instruments that intends to include a generic overview of models in common use and the principles on which they are based. This may be helpful in this context.

We agree that the valuation model used should be disclosed but this disclosure should be made at the time that the valuation is reported (and in the case of an external valuation, when the valuation is commissioned). Specifying the model to be used in the policy document creates an inflexibility that could lead to valuations that do not reflect current market practice.

² IVS 250 Financial Instruments paras C31- C35

Box 57 Here, and possibly in contrast to Box 55 (1), valuation policies and procedures are treated as distinguishable from designated “methodologies”. Because of the uncertainty over what is meant in this paper by the word “methodology” we are in turn uncertain how to respond. We agree that, subject to the review process advocated in Box 58, valuation policies and procedures should be applied consistently. An AIFM should not be allowed to “cherry pick” different procedures for similar assets held in different funds. However, if the references to “methodologies” and valuation sources is intended to mean that consistent methods must be used to value different assets held within a fund at the same time or to value the same asset at different times we again point out that this would be contrary to good valuation practice and would potentially create an artificiality in AIF valuation that would be against the interest of investors.

We again recommend that a clear distinction is made between an AIFM’s valuation policies and procedures and the valuation process itself. The former should be applied consistently and the latter should be undertaken in accordance with recognised standards and with market practice at the date of valuation, which may mean that the methods used change as markets evolve.

Box 58 We support the need to review valuation policies on a regular basis. However, for the reasons already indicated, valuation methodology, methods or models should not form part of an AIFM’s valuation policy. The IVS require the most appropriate approach or method on the valuation date to be used to determine value, and therefore review should occur each and every time a valuation is undertaken.

We recommend that the references to “methodologies” are removed.

Box 59 We have no comment to make on the proposals in Box 59 for the AIFM to review valuations for reasonableness. These appear to be sensible and desirable from the perspective of investor protection. However, we have concerns at the implications of the second sentence of the explanatory text in paragraph 17, ie *“This would mean that the assets have been valued in line with the valuation policies and procedures.”* We have already explained why the valuation policies and procedures should be confined to what is to be valued, when it is to be valued and who it is valued by. The valuation policy should not concern itself with how valuations are to be undertaken, which is a matter for valuation standards. The interests of investors depend upon assets being valued in accordance with the realities of the market and market practice on the valuation date, not on adherence to a predetermined method or model.

We recommend that the second sentence of paragraph 17 is deleted.

Box 60 We have no comment to make on the calculation of Net Asset Value.

Box 61 We realise that the term “professional guarantees” comes from the AIFMD. It nevertheless remains a poor use of language that may confuse and reduce the number of external valuation providers willing to value assets within an AIF. The word guarantee implies that the professional providing it is underwriting the outcome of the valuation. It is clear from the proposals set out in the Consultation Paper that this is not the case. All that is required is a statement confirming matters relating to the external valuers experience, status and any required regulatory approvals.

To avoid misinterpretation of the information requested and the intention for requesting it, we recommend that the document required is called “Professional Information” or a “Professional Certificate” rather than a “Professional Guarantee”.

Box 62 Our comment on paragraph 7 relates to the frequency of valuations. While we do not disagree with anything proposed or the explanatory comments, we note the example given of real estate as an asset that cannot be valued as frequently as subscriptions and redemptions. However, it may be appropriate to emphasise that an asset such as real estate can, and should, be valued more frequently than once a year if conditions dictate. We are aware that in some jurisdictions within the EU regulations require real estate CISs to be valued at intervals of not less than three months. However, in the rapidly falling market in late 2008 some fund managers were updating real estate valuations at fortnightly intervals.

We support the proposal that an AIFM be required to revalue if there is evidence that the last determined value is no longer fair and/or proper.

Other Comments

Having provided our comments on the proposals set out in the Consultation Paper we now turn to a matter that is not addressed in the paper but which is causing continued concern to many of our constituents. This is the following provision in the AIFMD Article 19 paragraph 10:

“However, notwithstanding the above and irrespective of any contractual arrangements providing otherwise, the external valuer shall be liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer’s negligence or intentional failure to perform its tasks.”

The IVSC expects professional valuers to accept responsibility for their actions and accepts that they should be accountable to their clients for acts of negligence or breaches of contract. However, this paragraph potentially imposes a liability on an external valuer that goes significantly beyond that which is normal in law. For example, it is common practice for many clients to accept a cap on a valuer’s liability in return for a lower fee. Such an arrangement would appear to be overridden by Article 19-10. As a consequence, the cost of external valuations may be expected to rise, a cost ultimately borne by investors.

The apparent prohibition on the AIFM and an external valuer's ability to agree commercial terms including reasonable limits on the valuer's liability is also likely to be unacceptable to professional indemnity insurers. If valuers cannot obtain indemnity insurance for this work, the number of firms available to undertake external valuations of funds will fall, thus again increasing costs.

The request to ESMA from the EU Commission did include considering the "professional guarantees" to be provided by an external valuer. While ESMA has interpreted this as referring only to the provision of professional information (see Box 61), Article 19 -10 is effectively requiring the external valuer to provide an unlimited guarantee against losses arising from negligence or omission to the AIFM.

Unless some detailed implementing measures can be introduced that indicate that agreed and realistic liability limits are not prohibited and clarifying what is deemed a loss suffered by the AIFM or what constitutes an intentional failure to perform by an external valuer, we are concerned that very few valuation providers will be available to the AIF industry. This would be inevitably increase the cost of obtaining external valuations and reduce the propensity for AIFMs to seek them. Neither of these outcomes would be in the public interest.

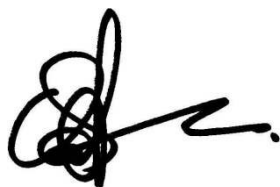
Conclusion

We recognise that the section on valuation is only a small part of the overall implementing measures. However, we believe that it is of vital importance that investors can access recent and relevant information about the value of assets held in funds and it is important that these valuations are conducted and reported in accordance with internationally accepted norms and best practice.

IVSC and its constituents have had many years experience in developing valuation standards and supporting guidance for a wide range of asset classes that provide transparency and protection for valuation users. We are willing to assist ESMA in reviewing the implementation measures for valuations in order to ensure that they are consistent with and promote best practice, and avoid the ambiguities that exist in the current draft.

If you would like to discuss any aspect of this letter or require more information on the International Valuation Standards please do not hesitate to contact the writer

Yours faithfully

A handwritten signature in black ink, appearing to be 'C G Thorne', with a stylized flourish at the end.

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