

Guidance Note No 26



Asset Valuation and Unit Pricing/Crediting Rates for Infrequently Valued Assets

[NOTE: This version of Guidance Note 26 incorporates changes to accommodate the introduction of FSC Standard 8A on “Crediting Rates”. For further information or to obtain a marked up copy, please contact David McGlynn, FSC Senior Legal Counsel, on (02) 8235 2534 or dmcglynn@fsc.org.au.]

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| FSC Membership this Guidance Note is most relevant to: | This Guidance Note applies to FSC Members generally and in particular Members who are Operators of a Scheme using Unit Pricing or Crediting Rates. |
| Date of this version: | 1 July 2018. |
| History (prior versions) of this Guidance Note: | This Guidance Note was originally issued on 10 December 2008 and amended in February 2010. |

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| Main Purposes of this Guidance Note: | <p>The purposes of this Guidance Note are as follows:</p> <ul style="list-style-type: none">(a) To specify the principles for Asset valuation in the calculation of unit prices or Crediting Rates when transactions may take place in Schemes which are substantially invested in infrequently valued Assets;(b) To provide guidance in the interpretation and application of those principles; and(c) To standardise the practices and procedures relating to Pricing/Crediting Rates to determine Interests in a Scheme. |
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1 Title

- 1.1 This Guidance Note may be cited as **FSC Guidance Note No 26** Asset Valuation and Unit Pricing for Infrequently Valued Assets.

2 Application

- 2.1 This Guidance Note should be applied by the Operator of a Scheme, whether the Scheme is offered for public subscription or otherwise, in determining Crediting Rates or the price at which transactions by Investors in Scheme Interests may take place where the underlying Assets of the Scheme are substantially invested in infrequently valued Assets.

- 2.2 The principles in this Guidance Note apply to:

-) open ended Schemes that allow Investors to transact on a regular basis; and
-) closed ended Schemes (where Investors cannot transact at regular intervals)

- 2.3 This Guidance Note does not apply to listed Schemes.

- 2.4 This Guidance Note should also be applied with reference to and read with:

-) FSC Standard No 8 – Scheme Pricing;
-) FSC Standard No 9 – Valuation of Scheme Assets and Liabilities,
-) FSC Standard No 8A – Crediting Rates; and
-) FSC Guidance Note No 1 – Global Investment Performance Standards

- 2.5 The interpretation contained within this Guidance Note does not take into account every specific unit pricing/crediting rate circumstance, and hence consideration should be given to each specific situation. In particular, consideration should be given to the Scheme's Constituent Documents and any legislative, regulatory and other applicable obligations or guidelines applicable to the Scheme Operator.

3 Statement of Purpose

- 3.1 Main features and purpose of this Guidance Note are:

-) To specify the principles for Asset valuation in the calculation of unit prices/crediting rates in Schemes which are substantially invested in infrequently valued Assets;
-) To provide guidance in the interpretation and application of those principles; and
-) To standardise the practices and procedures relating to the pricing/crediting rates of Interests in such Schemes.

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4 Statement of Principles

- 4.1 The principles to be adopted in the Asset valuation and unit pricing/crediting rates for infrequently valued Assets are:

To maintain Investor equity, Scheme Operators need to monitor the movement of Scheme Asset values within a portfolio between periods, and must revalue any Scheme Assets where there is a significant difference between the value of the portfolio used for Scheme pricing/crediting rates and the current market value (as estimated by the Scheme Operator based on monitoring of triggers outlined in paragraph 7.6 below) of the portfolio. This can be achieved through updated valuations or estimates.

- 4.2 If such an updated valuation or estimate cannot be performed to give a value certainty, the Scheme Operator should delay processing transactions until such a time that current valuations can be included in Scheme pricing/crediting rates.
- 4.3 Failure to update valuations of affected Scheme Assets in a timely fashion can result in the unit prices/crediting rates of the Scheme not reflecting the current market value of the underlying Asset portfolio. Transacting Investors may be impacted, and any transactions may have a subsequent impact on the remaining Investors in the Scheme.

5 Definitions

- 5.1 In this Guidance Note:

-) 'Assets' are defined in accordance with applicable Australian Accounting Standards and generally accepted accounting principles;
-) 'Constituent Documents' of a Scheme means the material governing rules and documents, including but not limited to the PDS, constitution, Trust Deed or IM, under which the Scheme exists;
-) 'Infrequently valued Assets' means any Asset which is valued at a frequency less than that in which Interests in the Scheme can be transacted. Generally these Assets are illiquid in nature (i.e. cannot be easily bought and sold within a short time period). These include unlisted Assets, commercial properties, infrastructure Assets, private equity holdings, non-exchange traded securities, derivatives (e.g. CDOs, mortgages, over-the-counter swaps etc), hedge funds and Assets for which there is no observable immediate market or Market Price;
-) 'Interest' means an undivided portion of the equity of a Scheme;
-) 'Investors' has the same meaning as in FSC Guidance Note No. 5 'Industry Terms and Definitions';
-) 'Market Price' means the last sale price immediately prior to the Valuation Point or the current price available at the Valuation Point from a market maker;

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- J 'Market value' means the current price that an investor is reasonably expected to pay on an arm's length basis in normal circumstances as a going-concern where there is a willing buyer and seller, i.e. not under pressure to sell. This is not necessarily the last quoted price;
 - J 'Operator' has the same meaning as in FSC Guidance Note No. 5 'Industry Terms and Definitions';
 - J 'Scheme' has the same meaning as in FSC Guidance Note No. 5 'Industry Terms and Definitions'; and
 - J 'Valuation Point' means the point in time at which a cut-off is made to value the Scheme's Assets and Liabilities.
- 5.2 Unless the context requires otherwise, other terms defined in FSC Guidance Note No 5 *Industry Definitions*, FSC Guidance Note No. 31 *Provisioning for Deferred Tax Assets*, FSC Standard No 8 *Scheme Pricing* and FSC Standard No 8A *Crediting Rates* have the same meaning in this Guidance Note.

6 Interpretation

- 6.1 Due to the practicalities and costs involved with obtaining frequent valuations for illiquid Assets, Scheme Operators have typically valued them less frequently than Investors can transact in the Scheme. This could result in Interests in a Scheme being transacted at prices which do not represent the current value of its Asset portfolio, potentially diluting or enhancing other Investors' Interests in the Scheme, at the expense of member equity.
- 6.2 In applying paragraph section 10.6.1 of FSC Standard No 8 – *Scheme Pricing* and/or FSC Standard No 8A- *Crediting Rates* to this circumstance, Scheme Operators should establish appropriate measures to ensure that equity is maintained between transacting and non-transacting Investors. In *Regulatory Guide 94 Unit Pricing - Guide to Good Practice*, ASIC/APRA suggest that there should be a reasonable basis for estimating the unit price between valuations. This principle also should be applied in the context of crediting rate calculations and methodologies.

7 Example of Application

- 7.1 Scheme Operators should implement a set of policies that are reviewed and approved by the Board or duly authorised sub-committee, and submitted for review and approval to the board or sub-committee every twelve (12) months.
- 7.2 The Scheme should nominate an appropriately authorised committee dedicated to the oversight of the valuation process of infrequently valued Scheme Assets. Members of this body should include individuals who are not involved in the day-to-day execution of the valuation process, and should be from a diverse background across the organisation. The number of members who are rewarded or whose superiors are rewarded on the basis of portfolio

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performance should be limited and not hold a majority membership of the committee.

- 7.3 Valuations of Assets should be sought from independent third party valuers wherever possible. Where such a valuer is used, the Scheme Operator should consider rotating valuers every three (3) years. Scheme Operators should satisfy themselves as to the credentials of the independent valuer. The set of policies referred to in paragraph 7.1 should disclose how the Scheme Operator applies information received from independent third party valuers to the valuation.
- 7.4 Where the Scheme Operator relies on an Asset valuation provided by an Investment Manager, the Scheme Operator must satisfy themselves that they have adequately managed the potential conflict of interest that may arise. A non-exhaustive list of potential conflicts in such circumstances is provided below:
-) Fees paid to an investment manager are impacted by performance of Assets under management.
 -) Investment managers may seek to avoid breaches of their mandate that would otherwise be revealed through mandate compliance monitoring.
 -) Investment managers may seek to maintain levels of capital in the fund above pre-determined minimums.
 -) Investment managers may seek to avoid negative publicity and any adverse client relationship impact associated with inferior fund performance.
 -) Investment managers may cyclically manipulate valuations between periods to maximise performance fees.
- 7.5 Scheme Operators should stagger valuations of Assets across the course of each year in order to moderate the extent of out-of-date valuations. However, it should be noted that this approach does not remove the risk of breaching the principles of paragraph section 10.6.1 of Standard No 8- *Scheme Pricing* during times of rapid market movement.
- 7.6 The Scheme Operator should regularly monitor Asset values to ensure that the Scheme's Asset values used for pricing/crediting rates are not significantly different to the current market value of those Assets. Asset prices can be monitored via a number of triggers, for example:
-) Changes in discount rates;
 -) Recent sales/similar Assets currently for sale;
 -) Significant revaluations of other similar Assets within the portfolio;
 -) Movement in an appropriate market index;

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-) Changes in the Asset profile, such as green ratings for commercial properties etc;
 -) Movements in the occupancy and rental yields for commercial buildings;
 -) Changes in interest rates;
 -) Change to tax rules;
 -) Changes in capitalisation rates; and
 -) Revenue and expense drivers for the underlying business.
- 7.7 Some illiquid Assets have an inevitable degree of uncertainty concerning individual valuations (eg. two independent valuations for a property could differ by say 10%). However, across a broad portfolio, these variations should average out, and there should be more certainty regarding the total valuation of the portfolio.
- 7.8 Where the value of the portfolio used for pricing/crediting rates significantly departs from the current market value of the portfolio (as estimated by the Scheme Operator based on monitoring of triggers outlined in 7.6 above), the Scheme Operator should obtain an updated valuation of the portfolio's affected Assets, either via a revised valuation of the Assets or by applying a discretionary estimate from, say, an updated valuation model or directors' estimate.
- 7.9 For example, a Scheme Operator may trigger a revaluation of any affected Assets if the value of the portfolio used in Scheme pricing/crediting rates deviates from the suspected current market value of the portfolio by more than 5%. The specific threshold adopted needs to consider the nature of the Assets, and the potential for transactions to occur at prices that would create inequities.
- 7.10 Where proprietary valuation models are used, the Scheme Operator must identify and mitigate model risk. Models should be independently assessed, and Scheme Operators should satisfy themselves as to the credentials of the independent assessor.
- 7.11 It is important to note that, in accordance with FSC Standard No 8 – *Scheme Pricing* and FSC Standard No 8A *Crediting Rates*, a Scheme Operator is required to suspend transaction (and pricing/crediting rates) where Scheme pricing cannot be determined. Hence, if a revised Asset valuation is impractical, the Scheme Operator should consider delaying processing the transactions until such time that unit prices/crediting rates could be updated to reflect a current valuation. Alternatively, the Scheme Operator should consider restricting the frequency and timing of investor transactions to the same frequency and timing as Asset valuations, subject to the Scheme's disclosures.
- 7.12 When updated valuations are obtained, Scheme Operators must not smooth the impact of the change in Asset valuation on unit prices/crediting rates. The updated Asset valuation should be used immediately in Scheme

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pricing/crediting rates. In respect of unit pricing this is also a requirement of the ASIC/APRA *Unit Pricing - Guide to Good Practice*.

8 Disclosure

- 8.1 Scheme Operators should set out the frequency of Asset valuation in disclosures to Investors. While disclosure of the frequency of Asset valuation is important, the disclosed practice should be considered a minimum requirement and should not prevent more frequent valuations to ensure investor equity. The principles of this Guidance Note should be applied to ensure that investor equity is maintained. Disclosure of a practice that results in significant inequities does not relieve a Scheme Operator of their duties under the Corporations Act to ensure a fair and equitable treatment to Investors.
- 8.2 Where valuations are carried out between full valuations, for example quarterly intermediate valuations based on the movement in a suitable index where full valuations are carried out annually, the frequency of both full and intermediate valuations should be disclosed to Investors. However, care should be taken not to disclose to the extent that the information could be used to facilitate arbitrage opportunities.