Guidance Note No 26.00

Asset Valuation and Unit Pricing for Infrequently Valued Assets

December 2008: Updated February 2010

The main features purpose of this Guidance Note is:

- **To specify the principles for asset valuation in the calculation of unit prices when transactions may take place 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 of interests in such Schemes.**

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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 Date of Issue

2.1 This Guidance Note was originally issued on 10 December 2008. An amended Guidance Note was issued in February 2010.

3 Effective Date

3.1 This Guidance Note is effective from the date of issue. Amendments to this Guidance Note are effective from the date of issue of the amended version of the Guidance Note.

4 Application

4.1 This Guidance Note should be applied by the operator of a Scheme, whether the Scheme is offered for public subscription or otherwise, in determining 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.

4.2 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).**

4.3 **This Guidance Note does not apply to listed Schemes.**

4.4 This Guidance Note should also be applied with reference to:

- FSC Standard No 8 – 'Scheme Pricing';
- FSC Standard No 9 – 'Valuation of Scheme Assets and Liabilities', and
- Global Investment Performance Standards (refer FSC Guidance Note No 1).

4.5 The interpretation contained within this Guidance Note does not take into account every specific unit pricing circumstance, and hence consideration should be given to each specific situation. In particular, consideration should be given to the Scheme's Constituent Documents, and the legislative obligations of the Scheme Operator.

5 Statement of Purpose

5.1 Main features and purpose of this Guidance Note are:

- **To specify the principles for asset valuation in the calculation of unit prices when transactions may take place 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 of interests in such Schemes.**

6 Statement of Principles

6.1 The principles to be adopted in the asset valuation and unit pricing 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 and the current market value (as estimated by the Scheme operator based on monitoring of triggers outlined in 9.6 below) of the portfolio. This can be achieved through updated valuations or estimates.**

- **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.**

6.2 Failure to update valuations of affected Scheme assets in a timely fashion can result in the unit prices 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.

7 Definitions

7.1 In this Guidance Note:

- **'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. can not 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.**

- **'Market value' means the current price that an investor is reasonably expected to pay on an arms 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.

8 Interpretation

8.1 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.

8.2 In applying section 10.6.1 of FSC Standard No 8 – 'Scheme Pricing' to this circumstance, Scheme operators should establish appropriate measures to ensure that equity is maintained between transacting and non-transacting investors. In their *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.

9 Example of Application

9.1 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.

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

9.3 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 section 9.1 should disclose how the Scheme operator applies information received from independent third party valuers to the valuation.

9.4 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

9.5 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 section 10.6.1 of Standard No 8 during times of rapid market movement.

9.6 The Scheme operator should regularly monitor asset values to ensure that the Scheme's asset values used for pricing 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;
- 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

9.7 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.

9.8 Where the value of the portfolio used for pricing significantly departs from the current market value of the portfolio (as estimated by the Scheme operator based on monitoring of triggers outlined in 9.6 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.

9.9 For example, a Scheme operator may trigger a revaluation of any affected assets if the value of the portfolio used in Scheme pricing 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.

9.10 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.

9.11 It is important to note that, in accordance with FSC Standard No 8 – 'Scheme Pricing', a Scheme operator is required to suspend transaction (and pricing) where Scheme pricing can not 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 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.

9.12 When updated valuations are obtained, Scheme operators must not smooth the impact of the change in asset valuation on unit prices. The updated asset valuation should be used immediately in Scheme pricing. This is also a requirement of the ASIC/APRA *Unit Pricing - Guide to Good Practice*.

10 Disclosure

10.1 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.

10.2 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.