

23<sup>rd</sup> March 2012

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Submitted to [Dp12\\_01@fsa.gov.uk](mailto:Dp12_01@fsa.gov.uk)

Re: **Implementation of the Alternative Investment Fund Managers Directive (DP 12/1)**

Dear Sir/Madam,

Markit<sup>1</sup> is pleased to submit the following comments to the Financial Services Authority (the “**FSA**”) in response to its Discussion Paper on the Implementation of the Alternative Investment Fund Managers Directive (the “**Discussion Paper**”).<sup>2</sup>

## Introduction

Markit is a service provider to the global financial markets, offering independent data, valuations, risk analytics, and related services for OTC derivatives and other financial products across regions and asset classes. Our products and services are used by a large variety of market participants to reduce risk, increase transparency, and improve operational efficiency in their financial markets activities.

The proper and independent valuation of funds’ assets by Alternative Investment Fund Managers (“**AIFMs**”) is an important function to ensure the protection of their investors and we appreciate that the Alternative Investment Fund Managers Directive (“**AIFMD**” or the “**Directive**”) has accordingly devoted significant attention to the topic of valuations. In order to promote the development of best practices, we believe that greater clarity is needed in relation to the concept of the External Valuer (“**EV**”) and the requirements that the Directive imposes on such entities. We believe that lack of clarity around these requirements could potentially disrupt established and sound valuation practices, meaning that the proper valuation of AIFM’s assets would be compromised, contrary to the Directive’s intention. Please find below our comments in relation to 1) valuation requirements, 2) external validation, and 3) External Valuer.

### 1. Valuation requirements

We generally agree with ESMA’s recommendations in relation to the proper valuation of AIFs’ assets. However, we believe that the requirement for the valuation of assets that are financial instruments to be aligned with the net asset value (“**NAV**”) calculation, i.e. “every time the NAV is calculated”,<sup>3</sup> would benefit from some further clarification.

We believe that, to protect investors of the fund, this requirement should be specific enough to ensure that the resulting NAV is as accurate as possible. In other jurisdictions, for example, funds are required to use “readily available” market quotations when calculating the fund’s NAV<sup>4</sup> and, where market quotations are

<sup>1</sup> Markit is a financial information services company with over 2,400 employees in Europe, North America, and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see [www.markit.com](http://www.markit.com) for additional information.

<sup>2</sup> Financial Services Authority DP 12/1: Implementation of the Alternative Investment Fund Managers Directive. January 2012.

<sup>3</sup> ESMA Consultation Paper 2011/209: ESMA’s draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. July 2011.

<sup>4</sup> Required by the SEC in the United States. See Investment Company Act of 1940 Section 2(a)(41)(B).

not readily available at that time, the securities would be marked at “fair value”.<sup>5</sup> On this basis the prices that are used for the valuation of the fund’s positions will be most representative of exit value *at the time of the NAV calculation* and will take into account all information that is available to market participants at that time.

## 2. External Validation

**Question 25: What are the most significant considerations that we should take into account when assessing the need to require AIFMs to have their valuation procedures and/or valuations verified by an external valuer or auditor?**

We believe that, in general, the need for verification of AIFMs’ valuation practices by an EV or an auditor might be limited. This is because, under current practices, each fund will perform an annual statutory filing, which will usually be audited by a statutory auditor. In order to sign a clean audit opinion the auditor must be satisfied that balance sheet and Profit & Loss account of the fund provide a true and fair reflection of the entities trading. This amounts to a de-facto review of the fund’s valuation practices.

That said, we believe that the FSA, when assessing the valuation practices of AIFMs that value internally, should ensure that their valuations are sufficiently independent, objective and standardised. The FSA should therefore require that, for example, valuations are prepared in accordance with industry best practice, the inputs for the valuations are provided by one or several independent sources, and the AIFM reviews them for quality, for example against historic valuations and/or sector benchmarks, before being released for use. Further, AIFMs should have sufficient controls in place to ensure that source data is checked for reasonableness and potential errors before use, processing is performed in accordance with documented procedures, and any queries or challenges are processed in a timely manner.

We believe that, particularly for some asset classes that are hard to value, the FSA will face challenges in verifying the above details. For funds of a certain size that invest in these asset classes, it might therefore be appropriate for the FSA to require the verification by an EV or by an auditor.

## 3. External Valuers

We believe that neither the Directive nor ESMA’s Technical Advice fully reflect the complexity of today’s valuation practices employed by AIFMs, including the variety of parties with various responsibilities that are involved in the process. We therefore urge the FSA to create some further clarification in respect to the definition and the duties of External Valuers.

### Current Valuation Practices of AIFMs

The FSA should be aware of the practices that many AIFM’s have established to ensure the proper valuation of their assets as part of the periodic calculation of Net Asset Value (“**NAV**”) for their funds:

- AIFMs will often procure asset-level valuations from multiple third-party pricing providers such as brokers or independent pricing vendors, in addition to the “marks” that they might receive from their counterparties.
- Many AIFMs have established pricing policies for their funds. As part of these policies they define an order in which the various pricing sources shall be used as input for the valuation of the fund’s assets.<sup>6</sup>

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<sup>5</sup> For instruments that do not trade at the time of the valuation, such “fair value” might be computed, for example, by the use of statistical factor models.

<sup>6</sup> For example, an independent vendor of pricing/valuation services such as Markit may be chosen by the AIFM to be the primary pricing source for bonds, while it may chose another vendor as the primary pricing source for CDS.

On that basis the AIFM will typically chose a pricing provider as primary pricing source for an asset class, and others as secondary (or tertiary) pricing sources.

- Most AIFMs will establish controls that are designed to monitor the appropriateness of the prices that they receive from the various pricing providers on a daily basis. In case that, on a particular day, the price received from the primary pricing source for a particular asset seems not appropriate,<sup>7</sup> the AIFM's pricing policy might specify the use of the price that it received for this instrument from another pricing provider that is further down the hierarchy but has managed to pass the relevant tests.
- Many AIFMs will outsource the practice of aggregating asset-level valuations and calculating the fund's NAV to an accounting agent, for example fund administrators and custodians. It will often be these fund accounting agents that procure asset-level valuations from third parties and, based on their knowledge of the fund's complete portfolio of assets, calculate the NAV of the fund.

### 3.1. Who is an External Valuer?

ESMA's Technical Advice provided some clarification in relation to the definition of an EV by specifying that a third party performing the calculation of NAV for an AIF is *not* considered an EV for the purposes of Article 19 of the Directive.<sup>8</sup> It went on to state that this would apply as long as such entity did not provide valuations for individual assets, including those requiring subjective judgement, but incorporates values that are obtained from the AIFM, pricing sources or the external valuer(s) into the calculation process. ESMA further clarified that a "price provider" is not regarded as an EV.<sup>9</sup>

Despite these clarifications, it is not clear which entities, if any, that play a role in today's valuation practices of AIFMs as described above, would be regarded as External Valuer under the Directive. There are a number of reasons why we believe that third party pricing/valuation providers should not be regarded as EVs:

- *Subjective vs objective valuations* - ESMA's advice suggests that the EV classification somehow depends on the level of subjectivity that is applied by the provider of the service, making it either a "price" or a "valuation" provider. However, in reality a whole continuum of pricing/valuation services exists that vary in the degree to which they are subjective.<sup>10</sup> It is unclear how and where the line between "objective" and "subjective" would be drawn.
- *Valuation on instrument vs position basis* - Any pricing/valuation service provides AIFMs typically only with an indicative mid price on an *instrument* basis. However, the actual level where an *AIF's position* is eventually valued will typically include further adjustments to reflect the position's size, the bid/offer spread, counterparty risk, and other idiosyncratic factors. Such adjustments will generally be made by the AIFM itself or by its fund accounting agent based on the fund's pricing policy. This holds true regardless of the level of subjectivity of the price/valuation provided, and applies also to highly subjective valuations.<sup>11</sup>
- *Actual use of valuations provided* - Generally, any pricing/valuation service will only provide an indication of current value for an instrument, which might or might not be used by the AIFM when it

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<sup>7</sup> This might be, for example, because it is missing, stale, or spurious.

<sup>8</sup> ESMA Final Report 2011/379: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. November 2011.

<sup>9</sup> ESMA Final Report 2011/379: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. November 2011.

<sup>10</sup> The relevant services range from the communication of transaction prices to the provision of consensus pricing, the use of evaluated pricing techniques, model-based derivatives valuations, and the valuation of private equity or real estate holdings.

<sup>11</sup> For example, 3<sup>rd</sup> party valuations of private equity investments that are based on quantitative models will generally not reflect factors such as key person risk, the risk of fraud, or control issues. The impact of these elements would typically be taken into account by the AIFM itself.

decides where to value its actual position. Third party pricing providers will rarely know their ranking within a fund's pricing policy and whether their price was used in the calculation of a particular day's NAV. Further, they tend to receive information only for the instruments that they are asked to value and will not generally know the composition of the fund's entire portfolio. Third party pricing providers, even though they provide pricing/valuation information that the AIFM might use to calculate and ensure the quality of the NAV, are therefore fully removed from the actual NAV calculation and the syndication of the share price to fund investors.

The AIF's NAV directly impacts the share price at which investors can invest into or redeem shares of the fund. For this reason it might have been appropriate to classify the calculator of the NAV as an EV. In contrast, third party pricing/valuation vendors for individual assets are generally not involved with the NAV calculation and, on any given day, the data provided by them might not even be used to calculate the NAV. We therefore believe that they provide a sufficiently exogenous service to not be classified as an EV.

We believe that, at this juncture, it is critically important to create clarity about which services would be considered EVs in the context of the Directive. Such clarity will be needed to avoid a situation where AIFMs might no longer be able to use the services of many of their current pricing/valuation vendors, which might result, in the extreme, in disrupting their established valuation practices.

### 3.2. Requirements for External Valuers

#### a) Professional Guarantees

***Question 26: What professional guarantees by an external valuer would be sufficient to show that it can meet the requirements of the Directive?***

The Directive requires EVs to provide "sufficient professional guarantees" to be able to perform the relevant valuation functions for AIFMs.<sup>12</sup> ESMA stated in its Technical Advice that EVs have to provide professional guarantees "in writing" as evidence of the EV's "qualification and capability to perform the valuation, including sufficient personnel and technical resources, adequate procedures safeguarding proper and independent valuation, and adequate knowledge and understanding".<sup>13</sup> In comparison, current market practice already expects providers of valuations to commit to performing their obligations in accordance with "Good Industry Practice".<sup>14</sup>

We believe that, as a practical solution to this requirement, the Professional Guarantees provided by EVs should consist of a) documentation providing reasonable assurance that the EV's process is executed consistently, and b) an agreement between the parties relating to the service which includes service levels to provide users of the service with sufficient assurance that the results will be provided to an agreed schedule of requirements. By implication, these documents would evidence that the EV has the competence and resources necessary to meet its obligations. On that basis, we believe that a SAS 70 registration in combination with a Service Level Agreement ("**SLA**")<sup>15</sup> should be acceptable as sufficient Professional Guarantees under the Directive.

#### b) Further requirements

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<sup>12</sup> Financial Services Authority DP 12/1: Implementation of the Alternative Investment Fund Managers Directive. January 2012.

<sup>13</sup> ESMA Final Report 2011/379: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. November 2011.

<sup>14</sup> "Good Industry Practice" usually is defined to be, in relation to any particular circumstances, the degree of skill, diligence, prudence, foresight and operating practice which would reasonably and ordinarily be expected from a reasonably skilled and experienced provider of equivalent services and/or data of a similar type to that provided under the same or similar circumstances and conducted in accordance with all applicable laws, rules and regulations.

<sup>15</sup> An SLA might cover the source data requirements on the client, the delivery schedules for valuation services once valid input data has been received, e.g. where full data has been provided, where partial data has been provided and further work must be performed by the EV to complete the data set before the valuation process can be run, and the response times following receipt of client queries and/or valuation challenges.

In addition, we believe that all stakeholders would benefit from the FSA's clarification in relation to some other requirements that are imposed on EVs:

### **Professional registration**

The Directive requires EVs to be “subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct.”<sup>16</sup> However, it is not clear how the majority of providers of pricing/valuation services to AIFMs, in case they were regarded as EVs, could comply with this requirement.

We are concerned that this requirement, without further elaboration, may be unduly restrictive. It seems that its literal interpretation would significantly and unnecessarily limit the pool of providers of valuation services to AIFMs to entities that are licensed by professional bodies, for example surveyors, lawyers, or chartered accountants. However, these professional bodies do not seem to provide an appropriate framework for the typical providers of valuation services.

We believe that there are two possible approaches to addressing this issue:

- Regulatory authorities interpret this requirement practically and permit AIFM's to appoint EVs who, in case they are not licensed by a professional body, are subject to statutory, common law and contractual requirements that are as effective in setting the standards for EVs as membership of a professional body.
- Regulatory authorities and the industry create appropriate registration mechanisms and categories for these providers. Specifically, the FSA might consider creating a regulatory regime for EVs. Such regime would provide EVs with guidelines that they would need to satisfy in order to provide a best practice valuation. It would also further define the basic requirements of EVs such as having in place the necessary Professional Guarantees as described in section 3.2(a) above.

### **Liabilities**

The Directive states that “irrespective of any contractual arrangements providing otherwise, the EV shall be liable to the AIFM for any losses suffered by the AIFM as a result of the EV's negligence or intentional failure to perform its tasks”. We believe that the liabilities that EVs would be exposed to need to be further clarified in order to avoid significant unintended consequences:

- We agree that acts of fraud, wilful misconduct or gross negligence by the EV in the performance of its services will incur liabilities. However, the ultimate responsibility to safeguard, manage the risks and value the assets of a fund must remain with the AIFM. Relief from this primary obligation would create an unnatural and undesirable relief of the AIFM from its fundamental obligation to its fund investors.
- Some of the assets held by AIFMs are inherently difficult to value. As their valuation often requires numerous assumptions to be made in relation to the occurrence of future events, some valuations that are provided today will almost invariably prove inaccurate in retrospect. Further, the data that valuation providers rely upon to produce their valuations is often provided to them by market participants and/or other data providers who do not provide any representation or warranty as to the accuracy of such data. Given the inherent uncertainty of valuations and the reliance on third party data and assumptions, exposing providers of valuation services to AIFMs to significant liabilities could force many of them to exit this market or significantly raise the cost of such services.

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<sup>16</sup> Financial Services Authority DP 12/1: Implementation of the Alternative Investment Fund Managers Directive. January 2012.



- According to current market practice, the providers of valuation services and their clients will address the apportionment of responsibilities and risks in their contracts in accordance with common law and contractual requirements. Typically, providers of valuation services will offer their services under mutually agreed contractual terms that limit their liabilities in respect of the performance of the service and the quantum of damages and losses. Due to the inherently uncertain nature of valuations, as stated above, it is market practice to include express disclaimers as to the accuracy of data, a limitation on the quantum of damages and losses, and a limitation on liability for consequential losses.<sup>17</sup>
- It is worth highlighting that it would be unusual under English contract law for two arms length commercial parties to be unable to contractually agree to limit their liability in the context of the particular commercial transaction between the parties. This is particularly true in relation to liability to "indirect" or "consequential" losses. Further, a "negligence" standard as opposed to "gross negligence" is also extremely uncommon for valid commercial reasons.

If providers of valuation services to AIFMs were not able to manage their liabilities with AIFMs contractually, many current providers would no longer provide their services to AIFMs, and high-quality independent valuations might no longer be available for certain asset classes which in turn would increase the inherent risk and uncertainty of AIFMs' valuations. Further, the cost of the remaining services would significantly increase given the cost these entities would face to insure themselves against such liabilities.

We believe that to maintain a competitive market for valuation services and secure the availability of high-quality, independent valuations to AIFMs, including those for hard-to-value assets, the FSA should clarify that the parties can mutually agree to contract to limit their liabilities in accordance with current contract law. Consistent with established market practice, EVs and AIFMs should be allowed to contractually agree to apportion their responsibilities and risks including limiting their liabilities, for example to the level of the relevant annual contract revenue, and exclude liability for indirect or consequential losses. Such approach should be acceptable provided that the EV can evidence the fact that it performed its contractual obligations to the contractual standard agreed.

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We appreciate the opportunity to comment on the FSA's Discussion Paper in relation to the implementation of AIFMD. We would be happy to elaborate further or discuss any of the points addressed above in more detail. In the event you have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at [marcus.schueler@markit.com](mailto:marcus.schueler@markit.com).

Yours sincerely,



Kevin Gould  
President  
Markit North America, Inc.

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<sup>17</sup> For example, parties to contracts often agree on a limitation on the quantum of damages for contractual breaches in the form of a specified cap or a liquidated damages clause. These limitations are not considered unreasonable by commercial parties or the English courts given that liability will often remain in the event of fraud, wilful misconduct or gross negligence.