SCI
Leading Structured Finance News

Compromised compliance

Buyside valuation controls scrutinised

It is almost two years since the transitional period for AIFMD expired in Europe and the majority of AIF managers now consider themselves to have addressed the Directive's requirements. However, as evidenced by regulator-imposed penalties in France, a number of managers have failed to implement adequate valuation controls.

Over the past 24 months the French regulator, the AMF, has sanctioned a number of investment managers for significant failings in valuation practices. Penalties were particularly severe for those firms whose failings led to subscriptions in redemptions on false NAVs, and ensuing financial losses for investors.

According to Ryan McNelley, md, Alternative Asset Advisory at Duff & Phelps, the AMF's actions are likely to be representative of the industry as a whole. "In France, it is now documented that there are pockets of managers whose valuation controls are not up to speed," he says. "I don't think the French managers are any better or any worse than those the UK. It may, however, be an indication of what may be uncovered if the same approach is taken in the UK."

Christophe Jacomin, partner at Lèfevre Pelletier & Associates, notes that the decisions published by the AMF mainly concern the manager's failure in risk control, lack of protection of the investors' interests and violation of the investment plan by the manager. He adds that while the AMF's decisions are publicly available, some decisions can be anonymous. "Indeed, the publication of a firm's identity constitutes an additional sanction," he says.

There are two types of investment manager investigation in France – an audit inspection to ensure firm is adhering to all obligations, and market abuse investigations based on observations on market activity by the regulator.

Hannah Rossiter, director, Compliance & Regulatory Consulting at Duff & Phelps, says that to the extent they are identified, failings in valuations are usually found during the normal audit process. "In most cases, the regulators won't go in specifically to look at valuation practices, she says. "However sometimes there are external indicators that may suggest to the regulator that there could be issues with valuation, such as funds that are significantly outperforming their benchmark or peers."

The inspection process by the AMF is ongoing. There are between 110 and 150 inspections per year, with roughly half being audit inspection and half market abuse. Of the cases surrounding valuation failings, there have been varying specifics. One of the earlier cases saw a manager fined for repeated under-valuation of an equity tranche of a CDO. More recently, a manager was sanctioned for issues around poor archiving and failing to document and justify pricing sources correctly. Further sanctions from the AMF surrounding valuation failings can be expected in the coming months.

Under the AIFM Directive, the required independent valuation function can be performed externally or internally, provided that the process is independent from the manager and there are no conflicts of interest. Failings or breaches in valuation functions may – or may not – come as a surprise to those active in the AIF space, however.

Oliver Fochler, managing partner and CEO at Stone Mountain Capital points out that although a portfolio manager cannot tell an external valuation party to value a position at a certain mark, this practice does take place.

“It does happen and the regulators know it happens,” he says. “For their part, regulators can do checks and black-mark certain managers for non-compliance with the Directive. But manpower-wise, it’s an almost impossible task: there are so many asset managers and so few enforcement personnel. We expect regulators to enforce the AIFMD, but institutional investors also need to be proactive: they must check the valuation policy in the prospectus very carefully and perform due diligence on the AIFs.”

Fochler suggests that wise investors will always check the valuation policy of an AIF. “If something doesn’t smell right, it’s usually not right,” he suggests. “This is specifically relevant in direct lending and illiquid credit strategy and how loans are evaluated. The valuations applied to the loans you manage will drive your performance and ultimately your compensation.”

He adds: “There are lots of tricks that can be applied and if investors don’t have an eye open for that they will be very likely negatively affected.”

In England, AIF managers await the FCA’s next move. Duff & Phelp’s McNelley suggests that when the FCA reviews AIF managers, there are likely to be questions around certain managers and whether they have met the requirements of the directive in good faith.

"In my experience there are some that will have, and some that won’t have,” he says. ”I wouldn’t say the AMF has been more aggressive or more on-the-ball than other regulators, it’s just that they have got there before the FCA or the other pan-European regulators.”

McNelley adds that all of the fines imposed by the AMF were related to the valuation of Level 3 assets. “Investors have a high degree of concern over assumptions and objectivity - valuation is probably the largest area of risk for them. “LPs don’t need the AIFMD to tell them where the risks are - they know what they are and have known for years,” he concludes.

This article was published on 03/05/2016 in PriceABS Insights, a content offering for Pricing & Valuation Professionals from SCI.