



1 June 2023

## Key takeaways from ESMA final report on the 2022 CSA on Valuation

### Background

In January 2022 ESMA [announced](#) the launch of a common supervisory action (**CSA**) with national competent authorities (**NCA**s) that would focus on the valuation of less-liquid assets held by UCITS and open-ended AIFs including unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, emerging markets, listed equities that are not actively traded and bank loans (**Less Liquid Assets**).

The objective of the CSA was to investigate whether authorised managers of UCITS and open-ended AIFs comply with the organisational requirements set out in the UCITS and AIFMD frameworks with respect to asset valuation; and adhere to valuation principles and methodologies with an objective to reflecting a true and fair view of their financial positions both under normal and stressed market conditions in line with the existing UCITS and AIFM valuation provisions.

On 24 May 2023, ESMA published its final [report](#) (**Report**) on the outcome of the CSA.

In this briefing, we provide an overview of the key takeaways for UCITS fund management companies and AIFMs managing open-ended AIFs (**FMCs**) arising from the Report.

### 1. Valuation Policies and Procedures

All FMCs should have in place documented, sound, transparent and well-established valuation policies and procedures (**Valuation Policy and Procedures**). The Valuation Policy and Procedures should appropriately document the valuation process implemented by the FMC; this is particularly important for Less-Liquid Assets given the material risk of inappropriate valuation arising for such assets.

The Valuation Policy and Procedures should also:

- (i) clearly define the valuation methodology to be applied for each asset class;
- (ii) clearly allocate operational tasks and responsibilities for asset valuation;

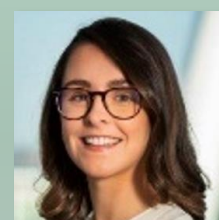
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- (iii) document the process applied to validate any valuation models used by the FMC; and
- (iv) identify those persons in charge of the validation of valuation methods who should have appropriate expertise and should not be involved in the process of building the valuation model.

The Valuation Policy and Procedures should be reviewed at least annually and in any event before the fund engages in a new investment strategy or a new type of asset that is not covered by the valuation policy. The valuation procedures and chosen methodologies are to be applied consistently across all funds managed by the same manager.

## **2. Valuation under stressed market conditions**

The Valuation Policies and Procedures implemented by FMCs, should distinguish between normal and stressed market conditions, and should provide a clear description of how results from liquidity stress testing carried out by FMCs in accordance with the [ESMA Liquidity Stress-Testing Guidelines](#) are considered in the valuation of assets.

## **3. Independence of the valuation function and use of third-party valuers**

FMCs must ensure the functional independence of the valuation function within their organisational structure. In this regard, the valuation function must be independent from the portfolio management team. FMCs should perform an independent analysis on the prices of the assets in the portfolio, especially on Less Liquid Assets, to ensure that valuation methodologies are robust, based on reliable data and/or verifiable assumptions, particularly under stressed market conditions.

Smaller FMCs should avoid over-reliance on third-party data providers for the pricing of Less Liquid Assets, and should perform the appropriate checks, controls and back testing on the valuation provided by such third-party data providers in order to ensure their accuracy and robustness under all market conditions. The criteria behind the selection of pricing sources should be duly justified and appropriately documented in the Valuation Policies and Procedures of the FMC.

The remuneration policy of the FMC and other measures implemented by the FMC should ensure that conflicts of interest are mitigated. In this regard, ESMA drew attention in its Report to conflicts of interest management where valuation-related functions are performed by third parties, in particular conflicts of interests stemming from third parties performing multiple potentially conflicting functions on a delegation basis and fee structures linked to the NAV.

The Valuation Policies and Procedures implemented by the FMC should be such that the undue influence of those employees involved in the valuation process is not permitted.

## **4. Early detection mechanisms for valuation errors and compensation to investors**

FMCs should ensure that their Valuation Policies and Procedures appropriately address the remedial procedures which have been implemented to ensure an early detection of valuation errors and, where applicable, that investors are appropriately compensated for any losses suffered by them as a result of such valuation errors.



## 5. Funds investing in Private Equity (PE) and Real Estate (RE) assets

Where FMCs manage funds which invest in PE or RE assets or any other Less Liquid Asset, they should ensure appropriate alignment between the NAV calculation, the asset valuation frequency and the availability of up-to-date data.

There should not be a variable degree of objectivity in the selection of valuation methodologies for Less Liquid Assets as ESMA notes that this can result in unreliable and/or incorrect valuations which will create unfair treatment of investors.

## Conclusion

Based on the approach which it has taken with previous common supervisory actions organised by ESMA, we would expect the Central Bank of Ireland to publish its own “Dear Chair” letter in due course, which is likely to identify its findings from the CSA and set out key actions which it requires Irish FMCs to take in the area of asset valuation. However, in the meantime, Irish FMCs should have regard to ESMA’s key findings outlined in the Report and identify any action which may need to be taken in order to align with ESMA’s expectations in the area of asset valuation.

We will keep you updated on relevant developments however in the interim, if you have any questions arising from this briefing, please get in touch with any of the authors or your usual contact in Dillon Eustace.

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**1 June 2023**



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