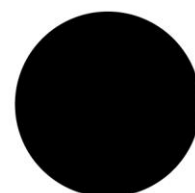


**STATEMENT SUPPORTING THE DRAFT CONDUCT
STANDARD ON NET ASSET VALUATION
CALCULATION AND PRICING FOR COLLECTIVE
INVESTMENT SCHEME PORTFOLIOS**

DRAFT



1 PURPOSE OF THE STATEMENT

- 1.1 The purpose of this document is to explain the need for, expected impact and intended operation of the draft Conduct Standard on Net Asset Valuation Calculation and Pricing for Collective Investment Scheme Portfolios (draft Conduct Standard) as required by section 98(1)(a) of the Financial Sector Regulation, 2017 (Act No. 9 of 2017) (FSR Act).
- 1.2 The objective of the draft Conduct Standard is mainly to ensure that:
 - investors are treated fairly by ensuring that regulatory risks in the valuation and pricing process are mitigated by introducing general principles to be supplemented by policies and procedures designed to appropriately address the valuation of assets by Collective Investment Scheme (CIS) managers;
 - investors are treated fairly by optimising investor protection by ensuring that asset valuations and portfolio pricing are not distorted to the detriment of investors; and
 - the Financial Sector Conduct Authority (FSCA) meets its international obligations in addressing the Financial Sector Assessment Programme (FSAP) findings of the International Monetary Fund (IMF) and comply with international standards set by the International Organisation of Securities Commissions (IOSCO).
- 1.3 The FSCA is intending to make this draft Conduct Standard pursuant to sections 114(3), read with 114(4)(b) of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002) (CISCA), and sections 106(1)(a), read with 106(2)(b) of the FSRA. These sections empower the FSCA to make conduct standards necessary to achieve the objectives of the FSRA and relevant financial sector laws, including CISCA. In this context the FSCA is empowered to make requirements relating to the valuation of assets and pricing of a portfolio of a collective investment scheme.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

- 2.1 Fairness to investor customers requires that there is a proper and transparent basis for asset valuation and the pricing and the redemption of participatory interests in a CIS.
- 2.2 Valuation of assets in a CIS portfolio is very important because a CIS must redeem and sell its participatory interests at their net asset value (NAV). The incorrect valuation of assets may have an adverse impact on investors in that certain investors may pay more for their participatory interests, some may receive less upon redemption and those remaining in the portfolio may also be adversely affected (as the remaining assets will be of less value when the redeemed participatory interests were overvalued).
- 2.3 Incorrect valuation may also give rise to the overstatement or understatement of assets which comes with its own complications and risks to investors, as described below.
- 2.4 According to an IOSCO report¹ on the principles for the valuation of CIS':

"The valuation of the assets employed or held by a CIS is critical to investors because it affects, amongst other things, the CIS's NAV, financial reporting, performance reporting and presentation, and fees paid to CIS service providers. Therefore, it is crucial to understand all the valuation drivers in order to reach a correct valuation of the assets in the portfolio or, before purchasing/selling an asset, in order to assess the correct value of such an asset."
- 2.5 The valuation of assets in a CIS portfolio could potentially present conflicts between the interests of investors and of those who value the assets in the CIS portfolio. An example of such a conflict could be that the CIS manager or other valuator could overstate the value of CIS portfolio assets

¹ Principles for the Valuation of Collective Investment Schemes, Final Report, IOSCO, May 2013, p.4.

in an attempt to attract more investors by demonstrating a more favourable position in an inflated performance record, resulting in the earning of higher management fees.

- 2.6 The current regulatory framework for CIS in South Africa currently only provides for certain high-level provisions in the CISCA and the Deed establishing a CIS. The CISCA does not currently provide for the determination of NAV within CIS portfolios in sufficient detail to enable proper regulation. The requirements in this regard are also not in line with international standards and regulation, with specific consideration of European legislation. In the past the Financial Services Board (FSB) mainly relied on the self-regulation by the CIS industry of net asset values within CIS portfolios. Notwithstanding, it is within the FSCA mandate to regulate the valuation and pricing of CIS.
- 2.7 A NAV is the total market value of all assets in a CIS portfolio including any income accruals, less any permissible deductions as contemplated in section 93 of the CISCA. CIS managers should properly value the assets within their portfolios, particularly in respect of those instruments for which market quotations are not readily available. Valuation is important because a CIS has to redeem and sell its participatory interests in accordance with its NAV as contemplated in Section 93 of the CISCA.
- 2.8 Following the previous FSAP, the IMF reported that the valuation and pricing of CIS portfolios should be significantly enhanced, i.e. the lack of specified valuation was reported as a negative aspect of South African CIS regulation.
- 2.9 In addition, the FSCA is a member of the IOSCO and its principles inform certain regulatory aspects, including the valuation of a CIS portfolio. As part of IOSCO membership, South Africa must comply with the international standards set by IOSCO.
- 2.10 For many years the Association for Savings and Investments South Africa ("ASISA") has published a Net Asset Valuation Standard applicable to its members (supporting the principle of self-regulation). During 2015, ASISA published its latest version which specifies principles to be adopted by ASISA members in calculating NAV's and NAV prices for CIS portfolios. These principles are, however, only applicable to ASISA members and have no external legal effect.
- 2.11 Therefore –
 - 2.11.1 there is currently a significant gap in the current CIS regulatory framework insofar as it relates to asset valuation in CIS portfolios; and
 - 2.11.2 the current CIS regulatory framework is not aligned to international standards and legislation.
- 2.12 There is therefore a need for an appropriate regulatory and supervisory framework for the valuation of assets in CIS portfolio, which gives adequate protection to investors in light of the potential risks of unfair outcomes described above.
- 2.13 In order to address the current gaps in the regulatory framework pertaining to net asset valuation calculation and pricing for collective investment scheme portfolios, and to align the regulatory framework for CIS with international standards, the former Registrar of Collective Investment Schemes embarked on a process to address the regulatory gap in calculating NAV and pricing for collective investment scheme portfolios by publishing a draft Board Notice for the Valuation of Assets and Pricing of Collective Investment Schemes (draft Board Notice) for public consultation in 2017.
- 2.14 The industry standard previously published by ASISA as well as international standards was to a large extent considered in drafting the Board Notice. Whilst the comments on the draft Board Notice was being considered and addressed, the FSR Act became effective and the FSB transitioned to the FSCA. Because of the introduction of the FSR Act, the draft Board Notice was converted to a draft Conduct Standard containing the same content as the previous draft

Board Notice, subject to amendments that were given effect to following the public comments received on the draft Board Notice.

3 SUMMARY OF THE DRAFT CONDUCT STANDARD

- 3.1 The draft Conduct Standard sets out principle- and rules-based requirements for CIS managers and fund administrators in respect of the valuation of assets and pricing of participatory interests of portfolios registered in terms of the CISCA.
- 3.2 The draft Conduct Standard places an obligation on CIS managers to implement policies and procedures governing the valuation of assets held by the CIS. It further requires that the policies and procedures must be consistent with generally accepted accounting standards or accounting practices as determined by the Authority.
- 3.3 According to the draft Conduct Standard a CIS manager must ensure accuracy in the calculation of the NAV and NAV pricing, and the pricing of the NAV must adhere to the principles of:
 - fairness, including that processes must be free from bias or discrimination;
 - consistency, including that processes must be applied consistently at all times;
 - transparency, including that processes must be clearly documented and data must be readily available for review in sufficient detail to enable detailed analysis and audit; and
 - accuracy, including that processes for accuracy must be designed and implemented to ensure that the inherent accuracy thereof is demonstrated.
- 3.4 The draft Conduct Standard requires CIS managers to consider and address issues relating to conflicts of interest in the design and application of their policies and processes.
- 3.5 The Draft Conduct Standard contains general principle-based requirements in conjunction with rule-based requirements regarding the determination of NAV pricing through the:
 - recording and valuation of assets within the portfolio;
 - recording of income received or accrued to the portfolio;
 - recording of expenses paid or accrued by the portfolio;
 - allocation of proportionate values to participatory interests; and
 - calculating and processing of distributions from the portfolio to investors.
- 3.6 The draft Conduct Standard further sets out disclosure requirements for portfolio data and requirements relating to dealing with pricing errors, including reporting of material errors in valuation and pricing to the Authority within 5 days after detection. Subsequent to the detection and reporting of the error, the manager has the responsibility to provide the Authority with a further report on the process and progress relating to the correction of the material error within 20 business days of reporting the error.

4 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

- 4.1 In light of the implementation and general acceptance of the ASISA industry standard (which largely informed the draft Conduct Standard) and in line with international best practice for the valuation of assets in CIS portfolios, the valuation of assets and pricing of the NAV of participatory interests are not new concepts to the CIS industry. The draft Conduct Standard will lead to more effective supervision of the CIS industry and formalise consistent pricing and valuation practices, which will result in enhanced investor protection, in line with the Authority's mandate.

- 4.2 The Authority acknowledges that there may be instances in which the implementation of the draft Conduct Standard could have a cost implication for CIS managers. However, in light of historical industry developments relating to the implementation of the ASISA standard dating back to 2015 and before, the potential cost implication is envisaged to be minimal as CIS managers are, to a large extent, already applying the requirements by virtue of their membership to ASISA.

5 STATEMENT OF INTENDED OPERATION OF THE CONDUCT STANDARD

- 5.1 The draft Conduct Standard is consistent with the objective of the FSRA, and specifically the mandate of the Authority to protect financial customers by promoting the fair treatment of financial customers (including investors) by financial institutions.
- 5.2 The draft Conduct Standard applies to CIS portfolios registered in terms of the CISCA, including CIS' in property where applicable, but excluding CIS' in participation bonds.
- 5.3 Where the draft Conduct Standard is silent on a matter related to the valuation of securities in a portfolio and determining the NAV price of a participatory interest, a CIS manager must implement alternative solutions which are consistent with the principles contained in the draft Conduct Standard and the CISCA as agreed with the trustee or custodian and included or to be included in a valuation policy.
- 5.4 The draft Conduct Standard is intended to come into operation 6 months from the date of final publication. The Authority, in consultation with ASISA, is also developing a more detailed Guideline to provide guidance in respect of valuation methodologies, which is intended to be published shortly after the publication of the draft Conduct Standard.

6 WAY FORWARD

- 6.1 The draft Conduct Standard will be submitted to Parliament for a period of at least 30 days while Parliament is in session.
- 6.2 For more information regarding the draft Conduct Standard and/or this statement please contact the Regulatory Framework Department of the Authority at Marius.DeJongh@FSCA.co.za.