1.1.2 OSC Staff Notice 11-763 - A Focused Review of the Securities Valuation and Expense Allocation Practices of Fund Managers

ONTARIO SECURITIES COMMISSION
STAFF NOTICE 11-763
A FOCUSED REVIEW OF THE SECURITIES VALUATION AND
EXPENSE ALLOCATION PRACTICES OF FUND MANAGERS

Overview

In late 2007, OSC staff conducted a focused review of the securities valuation and operating expense allocation practices of fund managers. This notice is a summary of the review, our observations and suggested practices.

We selected a sample of 26 fund managers with assets under management totalling $159 billion as at September 30, 2007. These fund managers vary in size and offer a wide variety of products, including mutual funds, pooled funds, closed-end funds and labour sponsored investment funds.

The review teams consisted of staff from the Compliance team of the Compliance and Registrant Regulation Branch and staff from the Investment Funds Branch. Starting in November 2007, we conducted the reviews at the fund managers' offices and assessed their practices from October 1, 2006 to September 30, 2007.

Purpose of the review

Our objectives were to review and assess:

- the appropriateness of the methodologies that fund managers use to value the securities in their funds' portfolios
- the practices fund managers follow in charging expenses to their funds. We focused on the operating expense component of the management expense ratio (MER).[1] We did not review the management fee component.

Securities valuation

Scope of the review

Our review included:

- reviewing and assessing the adequacy and appropriateness of fund managers' policies and procedures for valuing different types of securities
- testing the valuation of different types of securities
- reviewing the documentation to support securities valuation, particularly securities that do not have readily available market prices, such as privately issued securities, illiquid securities, certain types of derivatives and restricted securities
- comparing the disclosure of the valuation policies in offering documents against actual practices
- assessing the fund managers' oversight of suppliers where services were outsourced

Observations

Overall, the fund managers in our sample:

- had adequate policies and procedures for valuing portfolio securities
- were using appropriate valuation methodologies, particularly for securities that do not have readily available market prices
- were following practices that were consistent with the disclosure of their valuation policies

[1] MER is calculated by taking the total of the management fees, operating expenses and any performance fees, and dividing it by the fund's average assets for the period. Brokerage commissions and transaction costs are excluded from the MER calculation. The trailing commission paid to dealers and advisory fees paid to portfolio managers are usually included in the management fees of conventional mutual funds.

- were adequately overseeing service providers, including procedures to ensure service providers were following the fund manager's valuation policies

Policies and procedures

Fund managers generally had detailed policies and procedures on valuation, which they disclosed in the funds' offering documents. Their policies and procedures covered all types of securities in their funds' portfolios and provided guidance on the entire process of securities valuation.

Fund managers ensured that the valuation of assets and liabilities, and the calculation of net asset value (NAV) of the funds were prudently carried out. Their internal policies also covered situations where they might consider using estimated fair values instead of market prices.

Valuation of portfolios

The valuation methodologies used by the fund managers depended on the type of security and the availability of market quotations. Most securities in the fund portfolios were highly liquid exchange traded securities. The fund managers generally used an electronic price feed from an independent pricing vendor to price these securities. Most fund managers also validated these prices through a secondary pricing source, such as another independent pricing vendor, a custodian or a broker.

Fund managers in our sample had sound processes to fair value securities that did not have readily available market quotations, for example, privately issued securities. In general, they used acquisition cost until an arm's length transaction occurred that justified a change in value, for example, a new round of financing or a comparable third-party transaction. They clearly documented how they estimated fair value and the information they used to make the estimate.

As an added control, some fund managers had a valuation committee that met regularly to review the portfolios for appropriateness and reasonability.

Oversight of service providers

Many of the fund managers in our sample outsourced the valuation function. Fund managers typically maintained adequate oversight of these providers, although their approaches varied.

For example, fund managers:

- reviewed daily price variance reports for price changes above a pre-determined tolerance level (i.e. 5% to 10%)

- used stale price reports that identified all securities whose closing price had remained constant for the last five business days

- completed a reasonability review of the funds' NAV using a report showing the daily NAV, prior day NAV and the day-over-day dollar change and percentage change. Reasonableness was generally based on the movement of a fund's NAV compared to a broader market index.

We assessed the adequacy of fund managers' oversight by:

- reviewing their monitoring procedures

- testing a sample of their prices against an independent pricing source

- reviewing the service providers' CICA Handbook Section 5970 Report on Key Internal Controls and Safeguards, if the service providers chose to have their control procedures audited by an independent party

We noted that the fund managers in our sample had effective controls relating to the valuation of securities by their service providers.

Suggested practices

Fund managers should develop and enforce written policies and procedures that include, at a minimum, the following:

- valuation methodologies for all types of securities held in the funds' portfolios

- procedures to obtain prices from different pricing sources and process to be followed for securities that do not have readily available market prices

- procedures to identify and handle situations where prices obtained from the normal pricing sources may not be accurate, e.g. stale securities, halted securities or significant market events

- procedures to investigate price variances over a pre-determined tolerance level

- procedures to review and approve the valuation at the end of each valuation day prior to finalizing the calculation of NAV

- procedures for the identification, rectification and accounting treatment for NAV errors

Fund managers are ultimately responsible for those functions that they have outsourced to service providers. Fund managers should:

- enter into agreements that clearly outline the service providers' roles and responsibilities

- establish and document procedures to monitor service providers to ensure outsourced functions are performed properly, for example:

  - procedures to ensure that fund managers' valuation policies and procedures are being followed

  - guidelines on the frequency of communication between fund managers and service providers

  - the types and frequency of reports to be provided by service providers

- maintain records of their review of the outsourced functions

Fund manager should also consider establishing a valuation committee to independently review the securities in the funds' portfolios to ensure that valuation is done appropriately

Expense allocation practices

Scope of the review

Operating expenses[2] are incurred in the daily operation of a fund and include expenses such as accounting, audit, legal, transfer agent and custodial fees. Our review focused on the types of operating expenses fund managers charged to their funds and how fund managers allocated these expenses.

Our review included:

- reviewing and assessing fund managers' policies and procedures on accumulating and allocating operating expenses to the funds

- selecting samples of different types of operating expenses and reviewing documentation to assess whether the expenses were reasonable, appropriate and allocated fairly to various funds

- comparing expense disclosure in offering documents against the types of operating expenses actually charged

Observations

Overall, the fund managers in our sample:

- followed prudent practices relating to operating expenses

- used appropriate methodologies for allocating operating expenses to various funds

- clearly disclosed the types of operating expenses charged, including specific or unique expenses, such as the fixed administration fee

[2] Operating expenses make up the "ER" portion of the MER.

Allocating operating expenses

We noted that fund-specific operating expenses were easy to allocate to individual funds because they were supported by invoices that provided a breakdown of the expenses by fund. These included many of the standard operating expenses such as legal, audit, valuation and custodial fees.

In general, operating expenses that could not be directly linked to a particular fund were accumulated and allocated to the relevant funds. For example, some administrative expenses, such as accounting and information technology support, were accumulated and allocated to the funds that had used the services. Fund managers based their allocations on one or more appropriate factors, such as the number of fund investors, fund mandate, assets under management, the number of portfolio transactions or the number of classes in a fund.

Disclosure

The offering documents we reviewed contained appropriate disclosure relating to operating expenses. The disclosure included a general statement that each fund must pay all of its operating expenses and an itemized list of the types of operating expenses that could be charged to the fund. Fund managers used the term “administration expense” as a collective term for general expenses incurred to support the day-to-day administration of the funds that could not be easily itemized.

Suggested practices

Fund managers should establish and enforce written policies and procedures that include, at a minimum, the following:

- the types of expenses that should be borne by the funds
- procedures to ensure that invoices are reviewed and approved by an authorized person before they are processed for payment
- procedures to independently review expenses charged to the funds for accuracy and appropriateness
- a process to ensure that only those expenses disclosed in the offering documents are charged to the funds

Fund managers should also develop and document procedures used to budget and accrue for expenses in the funds, for example:

- procedures to prepare and approve the funds’ budgets at the beginning of each fiscal year to ensure that only reasonable and appropriate expenses will be charged to the funds
- procedures to monitor accrued amounts versus actual amounts on a periodic basis and guidelines on when an adjustment to the accruals should be made

When allocating expenses to the funds, fund managers should:

- clearly document the method used
- determine the appropriate factors to be used for the allocation and how they are applied for each type of expense
- ensure the allocation method is fair and reasonable to all funds

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