DUFF & PHELPS

SECURITIES AND FUTURES COMMISSION

February 22, 2017

Response – Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency

DUFF & PHELPS

Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

February 22, 2017

Re: Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-Sale Transparency

Dear Commission:

Duff & Phelps appreciates the opportunity to provide comments on the above referenced Consultation Paper.

Our advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques.

We would be pleased to further discuss our comments with the SFC. Please direct any questions to

Very truly yours,

Duff & Phelps LLC

General Observations

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We appreciate SFC's continued efforts in enhancing local regulatory requirements as international regulatory frameworks develop. We have set forth below a few observations on the *Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency* from the perspective of valuation and compliance specialists with extensive experience working with Alternative Investment Managers and Investors in Hong Kong and around the globe.

We believe that Fund Portfolio Valuation (within section 5) is a critical component of the FMCC and could benefit from a more coherent framework addressing valuation policies and procedures. Valuations and the valuation process is critical to both investors and to the fund. We recommend that the SFC incorporate guidance on fund valuation from existing industry best practice documents, including IOSCO's principles, Europe's Alternative Investment Fund Manager and industry specific publications such as the valuation guidelines published by IPEV (International Private Equity and Venture Capital Valuations Board).

In addition, the FMCC should incorporate an over-arching principle that *valuations should be determined in good faith.*

Responses to Questions

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We have provided responses only to those questions where we believe our input can enhance your conclusions.

Question 1 – Do you have any comments on the proposed clarification that the FMCC applies to the business activities carried out by fund managers which would include the management of discretionary accounts?

D&P response: We agree that all fund managers should be subject to the same regulatory framework.

Question 2 – Under the current proposal, some of the proposed enhancements are not applicable to all Fund Managers but only to those responsible for the overall operation of a fund or having de facto control of the oversight or operation of the fund. Do you agree with such an approach? If so, do you have any views on which of the proposed enhancements should only be applicable to those Fund Managers who are responsible for the overall operation of a fund or have de facto control of the oversight or operation of the fund? Please explain your views.

D&P response: The Fund valuation provisions (5.3.1 – 5.5.2) should be applicable to all fund managers, not only to managers who are responsible for the overall operation of the fund.

Please see our further comments with respect to section 5 below.

Question 8 - Do you have any comments on the above proposals regarding liquidity risk management?

D&P response: We agree that liquidity risk management is generally more relevant to open-ended funds. Private funds should be covered only to the extent of liquidity risk commensurate with their fund structure.

Question 9 - Do you have any suggestions on any particular liquidity management measures which a Fund Manager should put in place for effective liquidity management, for example, in terms of setting liquidity targets or stress testing?

D&P response: As noted above, liquidity management measures may need to differ between public and private funds and fund structures.

Question 10 - Do you consider it appropriate for Fund Managers to disclose the maximum leverage of the fund it manages to fund investors?

D&P response: Yes.

Question 12 - Do you have any comments on the other amendments proposed to the FMCC?

D&P response: Please see our additional comments below:

Section 1.10

It should be clarified that while a Fund Manager may utilize third party delegates, the Fund Manager is ultimately responsible for compliance with all applicable standards, especially with respect to valuation.

Section 5.3: Portfolio Valuation:

The FMCC should clearly distinguish between the valuation of assets and the calculation of the net asset value. A mechanical calculation of NAV performed by a fund administrator is not a valuation function when it does not entail the valuation of the underlying net assets. Most fund administrators do not have the expertise to value underlying assets, especially illiquid assets.

It should be clarified that independence in the valuation process does not relieve a Fund Manager from the responsibility to estimate fair value. The Financial Conduct Authority in the United Kingdom has drafted guidance with respect to demonstrating functional independence in the valuation process. We are happy to provide the SFC with our insights with respect to creating functional valuation independence.

When estimating fair value of underlying investments, in accordance with local and global accounting standards, the Fund Manager is ultimately responsible. Fiduciary responsibility for the assertions in the financial statements provided to investors and regulators cannot and should not be outsourced. As deemed appropriate, Fund Managers may utilize others, such as third party valuation specialists, to assist in the estimation of fair value. Investors need regular fair value information to exercise their own fiduciary, financial reporting, and management duties. Investors and regulators need fair value information, whether or not investments are included in a side-pocket.

It would be best practice to have the valuation policies and procedures periodically reviewed by an independent valuation specialist. In addition to introducing an independent review, this would facilitate developing policies and guidelines that are responsive to changing market conditions, regulatory and accounting developments, the emergence of new asset classes, and evolving views on investment aggregation (unit of account) applicable to valuation. A Fund's auditor would not be deemed independent with respect to audit work if they also opined on the valuation policies and procedures.

Comments we respect to specific paragraphs, follow:

- Paragraph 5.3.1: It should be made clear that an independent valuation process is not incompatible with the consideration of deal team knowledge of individual investments, especially private investments that are illiquid or infrequently traded.

- Par. 5.3.5 - All fund assets managed by a Fund Manager should be valued *every time the Fund Manager reports to investors or external parties* rather than at the Fund Manager's election at a frequency deemed "appropriate."

  Investors need regular fair value information to exercise their own fiduciary, financial reporting, and management duties. While the nature of the fund, frequency of transactions and asset types held have an impact on the required frequency of valuations, it is paramount that fair value be estimated with the same rigor at each investor reporting date. This is critical for investor protection and to allow investors to produce their own financial statements for internal and external use.

  In addition, the fair value measurement principle requires that each measurement consider contemporaneous information that is pertinent and available to market participants at each measurement date (i.e., it is not appropriate to use "old" valuations on a new reporting date if facts and circumstances have changed).

- Par. 5.3.6 should clearly lay out the standard (basis) of value for the fund valuations. Currently, "fair value" is mentioned twice (and 5.3.6 b. and e.). However, this is insufficient and fair value should clearly be set forth as the <u>measurement principle</u> underlying fund valuations, and a reference to the definition and fair value measurement framework should be provided. (We understand that the intent is to use the IFRS 13 definition of fair value.)

- Par. 5.3.6 b (i) – it should be made clear that the process of valuing an investment by using comparable transactions and applying professional judgment is also an appraisal process, i.e., should be performed by a valuation specialist or appraiser. However, as currently written, it appears that this is outside of the appraisal process, because only the next bullet (par. 5.3.6.b ii.) addresses appraisals of investments.

- Par. 5.3.6 b (ii) – makes reference to qualified accountants determining fair value. We believe this reference must be removed as valuations should be performed by valuation specialists (appraisers), not accountants or auditors.

- Par. 5.3.6 b (iii) – this guidance can be expanded to include not only information from independent sources, but also properly vetted internal deal knowledge.

- Par. 5.3.6. d (i) – should further explain that these should be *contemporaneous* and *actionable* quotes.

- 5.3.7 – Existing Fund Manager personnel and the Fund Manager's current auditor should likely be excluded from the review and testing processes set forth in this paragraph in order to maintain independence. Fund Manager personnel involved in updating the existing policies and procedures would lack the independence needed to fulfill this requirement. Further, as the Fund Manager's existing auditor will examine the results of the valuation process, there would be a violation of independence when performing both a review of the valuation policy/process and an audit of the results of that process.

- Paragraph 5.4: Investors need fair value information. All of the valuation requirements of section 5.3 should apply to Side Pockets. It should be made clear that the Fund Manager retains both responsibility and liability for the valuation of the assets and liabilities of the fund. The Fund Manager's liability towards the CIS and its investors is not affected by the fact that the Fund/Fund manager has appointed an external valuation agent. The Fund Manager cannot abdicate its fiduciary and professional duties with respect to financial reporting and valuation.

- Paragraph 5.5: Net Asset Value Calculation and Pricing: The calculation of NAV, derived in large part from the fair value of underlying investments, may functionally be assigned to a third party, though the Manager retains ultimate responsibility for valuation.