

OTC Derivatives Valuations – Status Report

Under the sponsorship of ISSA, a working party has developed best practice recommendations which were published in September 2008 (www.issanet.org):

- **Primary Valuation:** should be either a price independently calculated by a third party, or a price calculated by an independent unit of the Investment Manager
- **Verification of Valuation:** should be performed on a weekly basis by comparing the primary valuation versus either a third party independently calculated price or the price calculated by an independent unit of the Investment Manager (depending on which one is used for the primary valuation)
- **Additional Verification of Valuation:** should be performed on a monthly basis using the counterparty price versus the primary valuation

Summary of current regulatory frameworks for key markets

	UCITS	France	Germany	Ireland		Luxembourg	United Kingdom	United States
Primary Valuation Source	Counterparty valuation on a daily basis	Counterparty valuation on a daily basis	Fund Manager valuation	Counterparty valuation on a daily basis	Independent valuation calculated by the Collective Investment Scheme or by a pricing vendor on a daily basis	Counterparty valuation on a daily basis	Counterparty valuation on a daily basis	Best available fair market value source, which is reasonable in relation to the security
Alternative Valuation Source	Independent valuation using pricing models	Independent valuation using pricing models	Not clearly defined			Independent valuation using pricing models	Independent valuation using pricing models	Pricing model is acceptable when quoted prices are not available
Verification Procedure	Validated against an appropriate and independent third party source or independent unit within the UCITS	Validated against an appropriate and independent third party source or independent unit within the UCITS	All Fund Manager valuations must be verified by the Depot-bank / Custodian with an independent price	Verified by an independent party who is approved for the purpose by the trustee	Reconciled to the counterparty valuation	Validated against an appropriate and independent third party source or independent unit within the UCITS	Validated against an appropriate and independent third party source or independent unit within the UCITS	Not clearly defined
Verification Frequency	On an "adequate" frequency	On a "regular" basis	On a weekly basis	At least weekly	On a monthly basis	On an "appropriate" frequency	On an "adequate" frequency	Not clearly defined
Resolution Requirement	Not clearly defined	Not clearly defined, but industry practice is for the UCITS pricing committee for the fund to define the requirements	Not clearly defined	Not clearly defined	Significant differences must be promptly investigated and explained	Not clearly defined, but industry practice is for the UCITS pricing committee for the fund to define the requirements	Not clearly defined	Not clearly defined

Status

As far as we can ascertain, only a small number of organisations have in fact adopted these recommendations. The market as a whole has not yet embraced these proposed standards as "best practice".

Defining "best practice" is becoming increasingly difficult as:

- regulators in the key capital markets have yet to articulate new rules around the use of central counterparties for OTC derivative transactions
- collateral management and collateral policies are being redefined internally
- ISSA's recommendations are in parts contrary to market directives (e.g. UCITS directive 2007 on eligible assets)
- the AIFM directive, once completed and syndicated, is also likely to challenge some of the ISSA recommendations
- internal modus operandi still differ depending on the fund services provider

Next Steps

There is little benefit of reviewing and/or update the ISSA recommendations until the regulators and/or the industry bodies have confirmed their views and/or published corresponding directives/guidelines.

A new working party (see below) will take stock in Q4 2010.

Working Party

Markus Ruetimann (Chair)	Schroders plc
Darren Cannon	Schroder Investment Management, London
Costa Evolgimenos	JP Morgan, London
Stuart McClymont	Deutsche Bank, London
Diarmuid O'Donovan	UBS Fund Services, Luxembourg
Stefano Pierantozzi	Citi Fund Services, Luxembourg

Contact Details

International Securities Services Association ISSA
c/o UBS AG
FNNA OW6F
P.O. Box
CH - 8098 Zurich / Switzerland

Phone	+41 44 235 74 21
Fax	+41 44 236 14 74
e-mail	issa@issanet.org
Website	www.issanet.org