

NAV calculation errors or investment rule non-compliance

Link'n Learn – 13 September 2023

Getting Started

Here with you today



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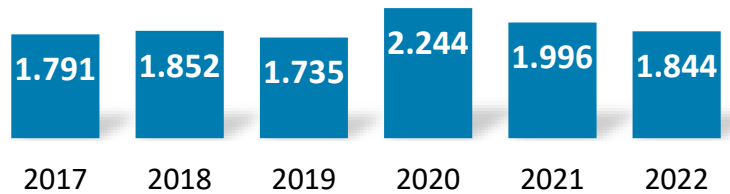
Agenda

- 1 Introduction
- 2 CSSF Circular 02/77
 - Decision Trees for NAV Calculation Errors and Investment Compliance Breaches
 - Calculation Methods
- 3 Overview of the FAQ on the CSSF Circular 02/77

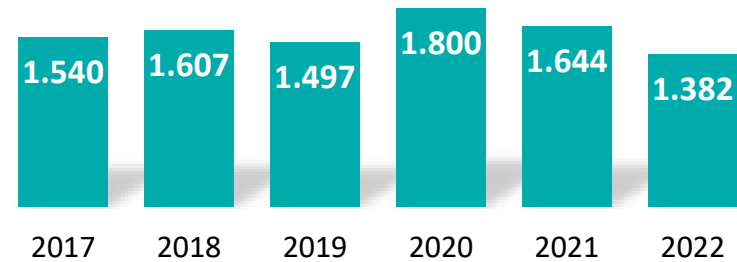
Introduction

CSSF Circular 02/77 - Set the scene

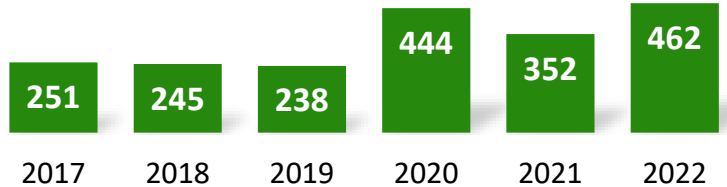
Number of notifications



Number of Compliance Breaches



Number of NAV calculation errors



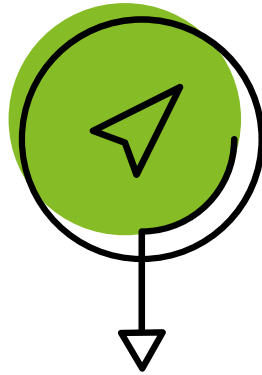
- Decrease of the number of notifications due to decrease in investment compliance breaches
- Increase in the number of notifications for NAV calculation errors
- Increase in the number of normal procedures (including compensation to investors)
- Global compensation increase but still very low compared to AUMs

Source : CSSF activity reports 2017 to 2022

CSSF Circular 02/77

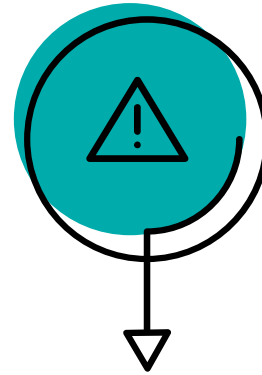
CSSF Circular 02/77

What is it about?



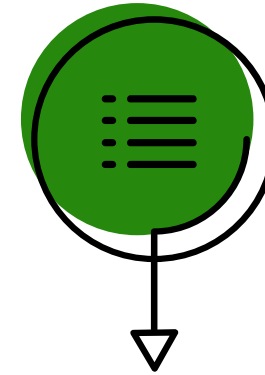
Purpose

To set out the **minimum rules** of conduct to be followed by collective investment professionals in **Luxembourg** in case of **errors/breaches** in the administration or management of **Part I and Part II Funds** and **SIFs***.



Errors/breaches

Resulting from the **incorrect calculation** of the net asset value or from **non-compliance** with the investment rules and/or restrictions.



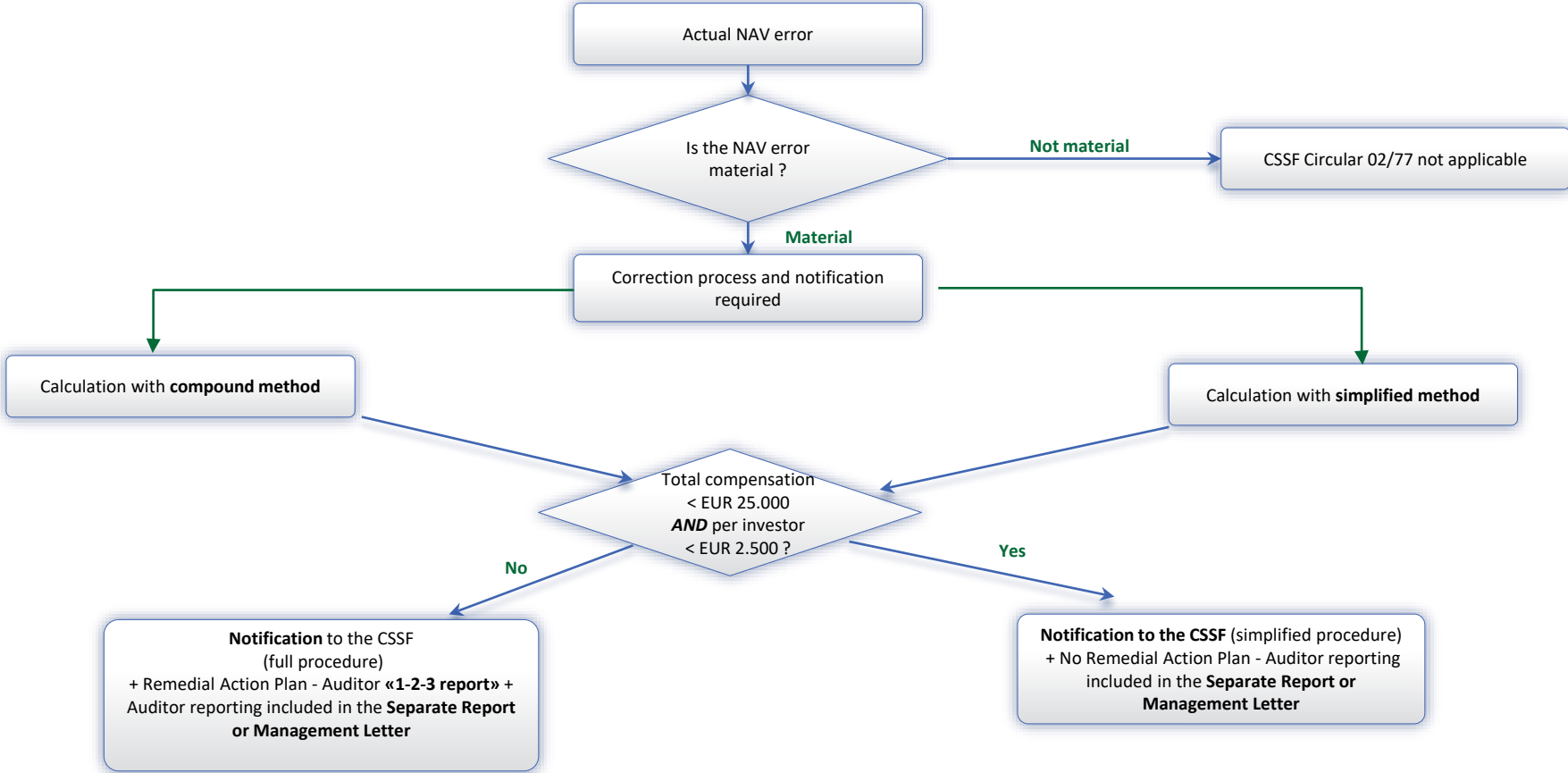
Responsibility

The **Board of the Fund and/or the Management Company** are responsible to ensure that any errors/breaches are correctly dealt with.

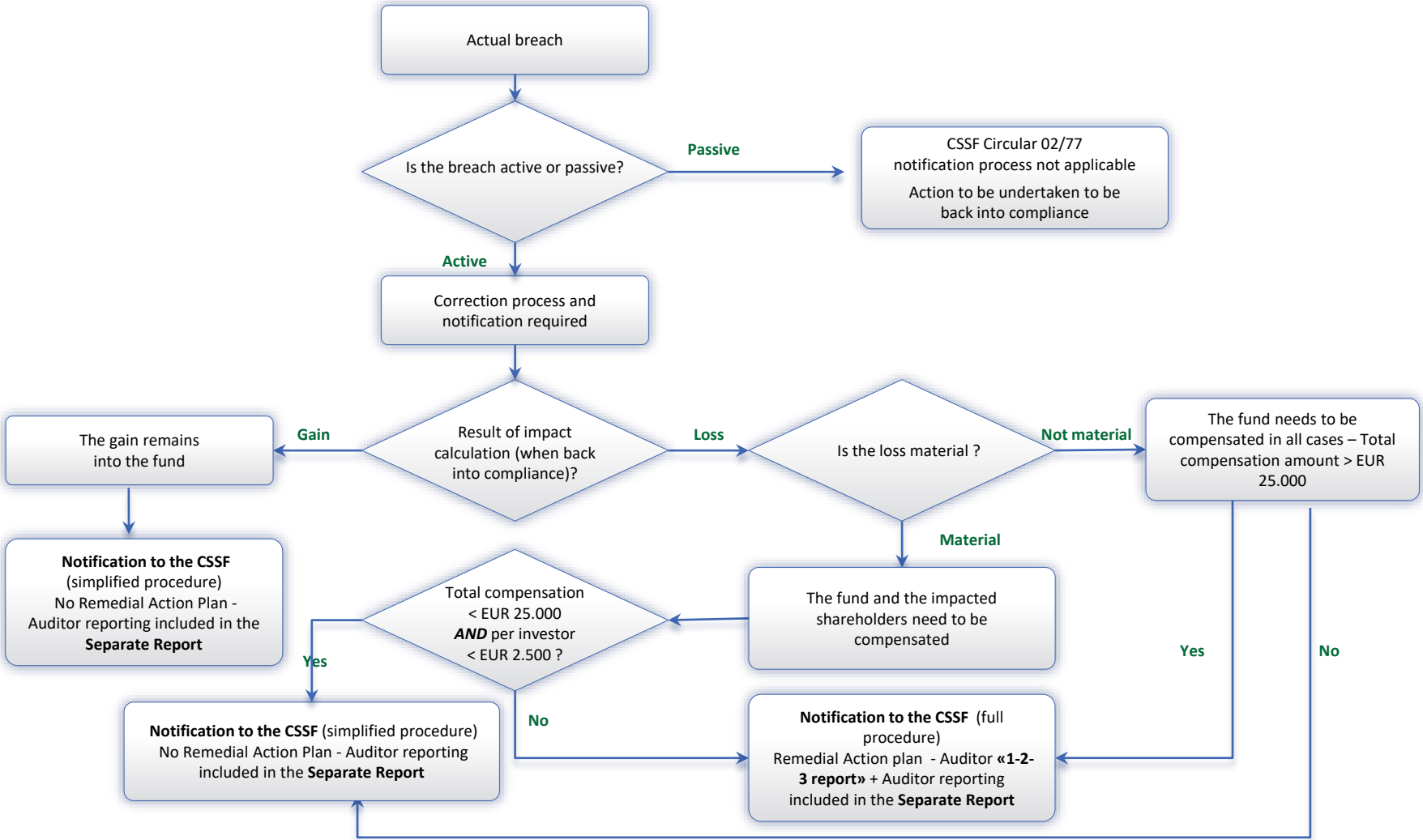
*CSSF is expecting a SIF to either adopts its own materiality or apply the 02/77 limits

Decision Trees for NAV Errors and Compliance Breaches

Decision tree for NAV Errors



Decision tree for compliance breaches



Calculation Methods

Calculation Methods for NAV errors

Principle = continuity of methods for NAV errors compensation

Simplified on material error (Focus on the error)

- Accepted by CSSF and auditors
- Does not consider the impact of the compensation to affected shareholders

Compound on material error

- Accepted by CSSF and auditors
- Consider the impact of the compensation to affected shareholders

SIF

Application of CSSF circular (default):

- Thresholds
- Compensation and reimbursement
- Also SIFs have to provide notification

Definition of (reasonable) internal rules:

- Define thresholds
- Correct and compensate errors exceeding threshold
- Etc.

Impacts calculation : economic and accounting approaches

Investment breach

Description: A fund has invested 21,6% of its TNA into the UCI “ABC” > 20% limit.

Breach Resolutions



Economic approach

“Opportunity cost”

Fair but subject to interpretation

The Board of Directors bases its approach on the **comparison of the fund UCI ABC with its reference index MSCI Europe**: would the manager have invested into securities of that index, the fund would have performed differently. In this example, let’s assume the “investment in breach” (UCI ABC) has performed better than the index (even if the performance is negative). No opportunity cost can be determined in that case, So, **no compensation** for the loss has to be paid.



Accounting approach

Pure accounting consideration

Easy to measure and implement

The Board of Directors bases its approach on **the impact calculation of the breach without comparing it with the reference index**.

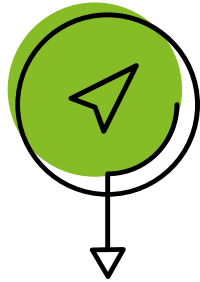
The result of the sale of the investment in breach is a loss. A **compensation amount** has to be paid.

Compensations are different depending on the method.
Consistency in the approach has to be applied at sub-fund level (when one method is chosen it has to be applied for all similar breaches in the future).

Overview of the FAQ on the CSSF Circular 02/77

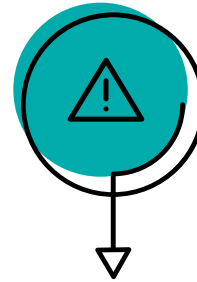
CSSF FAQ on Circular CSSF 02/77

In case of an active non-compliance by a UCITS of the cumulative investment restriction of Article 43 (2) of the 2010 Law (i.e. 5/40%), which securities should be sold to remediate the breach and what are the acceptable methods for calculating the related financial impacts?



3 methods accepted

- (a) calculate the impact by reference to the **security that caused the breach** by applying the **accounting method in proportion to the amount in breach**
- (b) calculate the impact by reference to the **security that has been sold** by applying the **accounting method in proportion to the amount in breach**
- (c) calculate the impact by using the **economic method in proportion to the amount in breach** i.e. impact being calculated by comparing the performance of the reference of the portfolio to the average performance of the securities having positions above 5% or to the performance of the securities that generated the breach with a consistent use of the method over time.

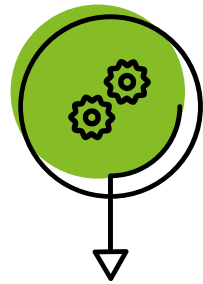


Exceptions

In case the internal policy of the IFM, does not lay down in writing the method to be used, **the CSSF considers that method (a) should be applied by default**, i.e.: calculating the impact **based on the security that caused the breach**.

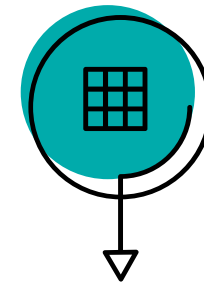
CSSF FAQ on Circular CSSF 02/77

Should the following situations be treated as an active investment breach by a UCITS of the 20% deposit limit of article 43(1) of the 2010 Law in accordance with the provisions of the Circular CSSF 02/77?



Predictability / avoidability principle

A settlement date mismatch is **predictable/avoidable** and thus not beyond the control of the fund, the CSSF considers related non-compliances with the 20% limit as active investment breaches



Organization

Generally speaking, the CSSF expects that the **organization of the portfolio management** by the Investment Fund Manager at the level of the UCITS (i.e. the investment operations, the cash management and the subscription/redemption flows) should provide for an **ongoing compliance of the 20% deposit limit**.

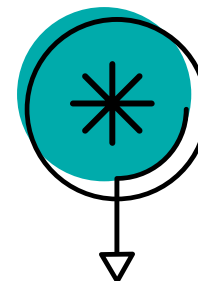
CSSF FAQ on Circular CSSF 02/77

In case of an active investment breach by a UCITS of the 20% deposit limit of article 43 (1) of the 2010 Law where the deposit returns a negative interest to the UCITS, can the UCITS calculate the financial impact of the breach by using a method which consists in comparing the interest rate return borne by the UCITS to the interest rate return of an equivalent deposit made with another credit institution?



No economic approach

The application of a method that consists in **comparing the interest rates between different bank accounts** to determine the financial impact is **not allowed**.

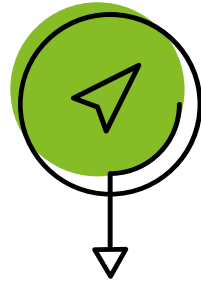


Accounting approach

The CSSF considers that a UCITS **should be compensated** in relation to the **interest rate and other charges** borne by the UCITS as a result of the excess deposit position.

CSSF FAQ on Circular CSSF 02/77

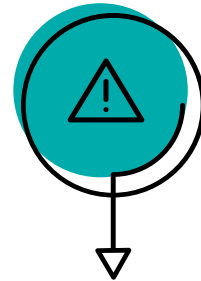
Does Circular CSSF 02/77 apply to NAV calculation errors and active investment breaches that occur in specialized investment funds (SIFs) subject to the Law of 13 February 2007



Notification process applies

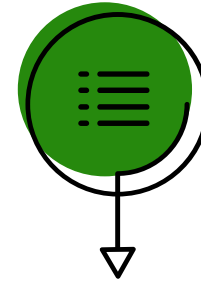
The CSSF considers that SIFs may **either opt for the application of Circular CSSF 02/77 or set other specific internal rules** applicable in the context of NAV calculation errors and active investment breaches.

In case of a material NAV calculation error or an active investment breach, **a notification needs to be sent to CSSF.**



No Remedial Action Plan

When SIFs opt for the provisions of Circular CSSF 02/77, **a remedial action plan need not be prepared** in accordance with Circular CSSF 02/77.

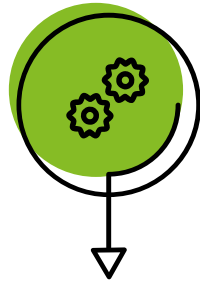


Management letter

The **approved statutory auditor** does however have to **review the correction process and the compensation** that remedy the situation and confirm in the **management letter** that they complied with the provisions of Circular CSSF 02/77.

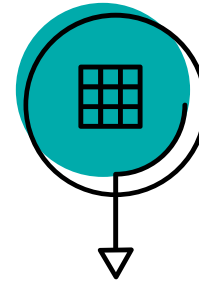
CSSF FAQ on Circular CSSF 02/77

When the UCI makes use of the de minimis amount for compensating the investors who are financially impacted in the context of a material NAV error calculation, should the UCI seek prior approval from the CSSF?



Justification of the level of the “de minimis” amount

The CSSF can ask the UCI to justify on an **ex post basis** the level of the “de minimis” amount applied and to provide documentary evidence that such amount represents the bank charges necessary to transfer the compensation amounts to investors (**notably where the “de minimis” amount exceeds EUR 25**).

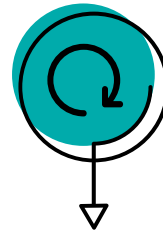


Internal policy

In addition, the **internal policy** of the IFM should provide for the use and the level of the “de minimis” amount in relation to NAV calculation errors

CSSF FAQ on Circular CSSF 02/77

What are the organizational requirements that apply in the context of NAV calculation errors and active investment breaches falling under the Circular CSSF 02/77?



Internal policy

- Governance process and the stakeholders involved
- Oversight of the delegate
- Definition of active vs. passive investment breach and applicable criteria
- Different steps, with the associated timeline
- Use and the level of de minimis
- Methodology used by sub-fund for the financial impact calculation in case of active investment breaches
- Application of the compound or non-compound method used by sub-fund for the financial impact calculation in case of material NAV calculation errors
- Periodic review of the adequacy and the effectiveness of the policy, processes and procedures applied in relation to Circular CSSF 02/77

CSSF FAQ on Circular CSSF 02/77

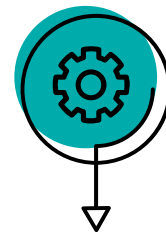
What are the conditions that UCIs have to comply with when applying the economic method to determine the financial impact caused to a UCI in the case of an active investment breach in accordance with Circular CSSF 02/77?



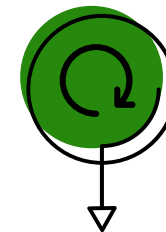
The selected reference is **in line with the investment policy** as laid down in the prospectus



Active investment breaches of the **same nature** occurring at the level of a given UCI are dealt with in accordance with the **same method**



It is **documented** in an adequate way in the **internal policy**



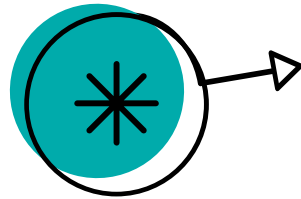
Do not prejudice the investors and have not been chosen with the objective to minimise compensation payments



The economic method can only be used if it is formally laid down in the internal policy of the IFM. Otherwise, the CSSF expects the accounting method to be used.

CSSF FAQ on Circular CSSF 02/77

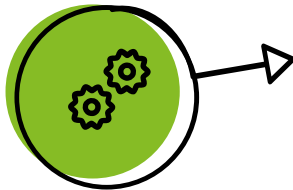
Is it possible, within the same umbrella to use the accounting method in some sub-funds and an economic method in other sub-funds?



Yes

In case of an umbrella fund, the choice of the methodology (“economic” or “accounting”) can be done for the entity **as a whole** or at the level of **each sub-fund individually**

Is it possible, within the same UCI, to use the accounting method to calculate the compensation amount for certain active investment breaches (e.g. article 50(2) of the 2010 Law) and to use an economic method to calculate the compensation amount for other types of active investment breaches (e.g. diversification limits of the 2010 Law)?



Yes

If this is **formally laid down in the internal policy** of the IFM and applied on a **consistent** basis

CSSF FAQ on Circular CSSF 02/77

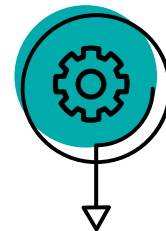
Under what conditions can a change of the method in the correction of an investment breach be accepted within the meaning of Circular CSSF 02/77?



Only possible if there is an **adequate justification** for such a change

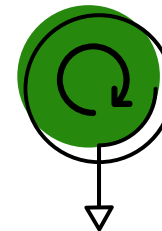


Has to **be approved by the Board of Directors** of the Investment Fund Manager and, if applicable, the Board of Directors of the UCI.



Change of the correction method is in principle **not allowed when it is decided in the context of the handling of a given investment breach**

The method can be **changed for a next investment breach of the same type** that will occur.



Consistency must exist in the application of the chosen method.



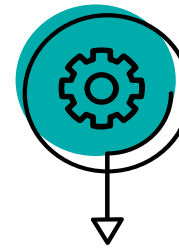
These conditions apply to any change of method (not only from accounting approach to economic approach).

In applying the economic method, what can be used as a reference benchmark?



Selected reference

The selected reference is only acceptable if it is a **fair representation of the investment policy** (or part thereof) of the UCI



Comparable assets

The method that only compares the performance of a non-eligible asset with a corresponding eligible asset is **not acceptable**.

Q&A

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NAV Doctor

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Appendix

Case study

Material NAV error – simplified vs. compound proc. Is impact with simplified method material?

Dividend distribution (EUR 10,000,000) not booked in NAV as at 08/01 - Equity Fund
 → NAV IS MATERIALLY OVER-STATED

Material NAV error >1%
 (Equity Fund)

Correction of the error on 15/01

NAV Date	Total NAV	# shares	NAV/share	Subs.	Red.	error amount	Corrected NAV	Corrected NAV/share	Error/share	Impact in %	Provision for subs.	Provision for reds
8-Jan	39.164.759,00	365.474,68	107,16									
9-Jan	39.150.194,84	365.474,68	107,12	-	-	10.000.000	29.150.194,84	79,76	27,36	25,54%		
10-Jan	39.188.437,56	365.380,97	107,25	150	243,71	10.000.000	29.188.437,56	79,88	27,37	25,52%	4.104*	6.668
11-Jan	41.014.901,77	382.380,97	107,26	27.000	10.000	10.000.000	31.014.901,77	81,11	26,15	24,38%	738.990	273.700
14-Jan	38.841.643,96	362.271,97	107,22	-	20.109	10.000.000	28.841.643,96	79,61	27,61	25,75%	-	525.850
15-Jan	36.952.552,41	342.389,68	107,93	21.000	40.882,29	10.000.000	26.952.552,41	78,72	29,21	27,06%	579.810	1.128.760

* error/share 9 Jan * # S subscribed on 9 and booked on 10 Jan

1.322.904,00 1.934.978,28

Cumulated impact (provision) 612.074,28

Cumulated impact as % of the NAV 1,66%

Case study

Material NAV error – simplified vs. compound proc.

Dividend distribution (EUR 10,000,000) not booked in NAV as at 08/01 - Equity Fund

→ NAV IS MATERIALLY OVER-STATED

Correction of the error on 15/01

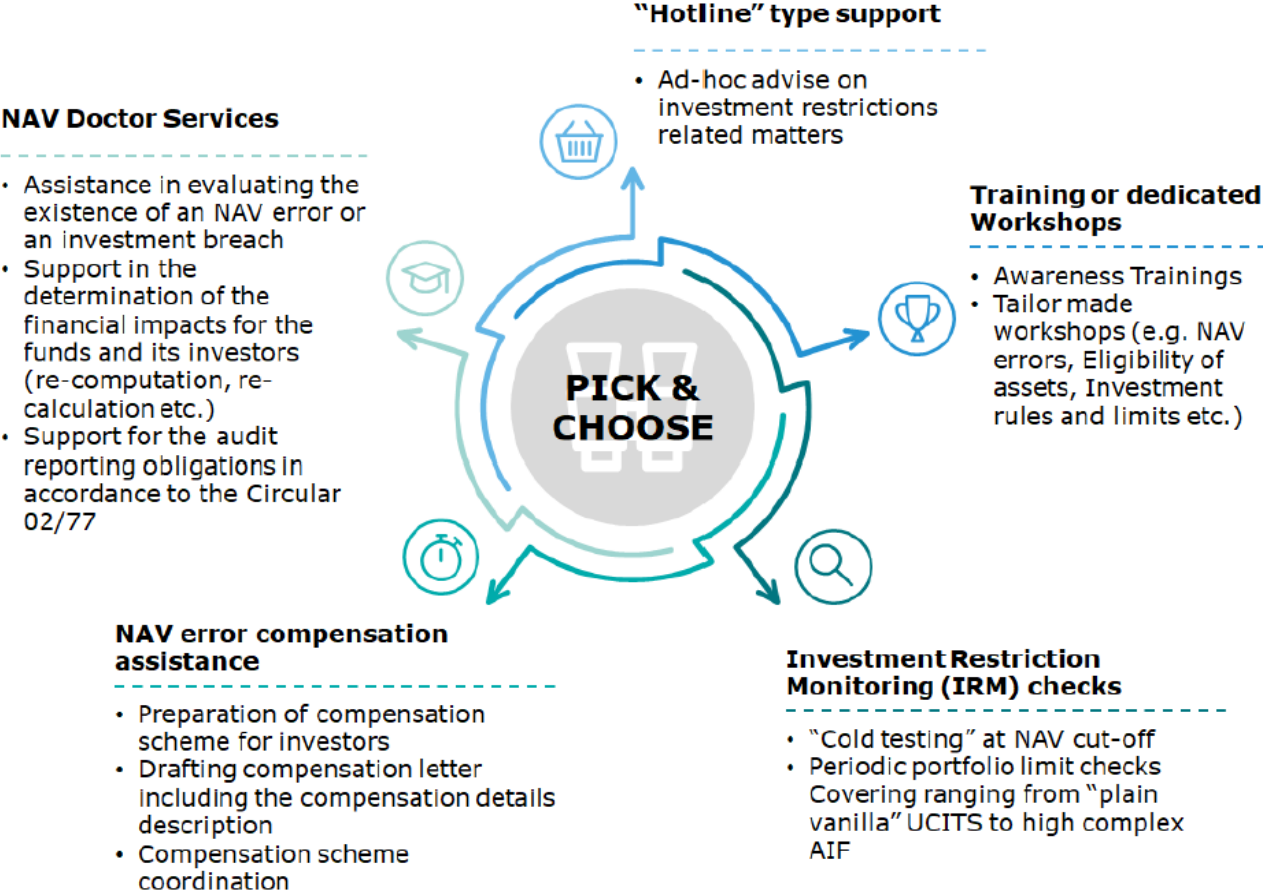
NAV Date	Provision for subs.	Provision for reds	Cumulated Provision	Total NAV corrected with the 2 nd impact (on wrong S/R)	NAV/share corrected with the 2 nd impact	Total error/share	Provision for subs. compound method	Provision for red. compound method	Cumulated Provision compound
8-Jan									
9-Jan				29.152.759	79,77	27,35			
10-Jan	4.104	6.668	2.564	28.725.711	78,62	28,63	4.103	6.665	2.562
11-Jan	738.990	273.700	(462.726)	31.078.026	81,28	25,98	773.010	286.300	(484.147)
14-Jan	-	525.850	63.124	29.453.718	81,30	25,92		522.432	38.285
15-Jan	579.810	1.128.760	612.074	27.564.627	80,51	27,42	544.320	1.059.669	553.634
	1.322.904	1.934.978					1.321.433	1.875.066	
		612.074	1,66%					553.634	1,50%

Impact with simplified method

Impact with compound method

Deloitte footprint, opportunities and services

Deloitte footprint, opportunities and services



Next Link'n Learn webinar

Date: 20/09/2023

**Topic: Investment Funds |
UCIs: Reduction of the
subscription tax rate for funds
investing in sustainable
investments**





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