



DECEMBER 2018

**SUMMARY OF SPOT INSPECTIONS  
ON THE VALUATION OF UNLISTED  
HOLDINGS IN PRIVATE EQUITY  
MANAGEMENT COMPANIES**

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## INTRODUCTION

As part of its new #Supervision2022 strategy, the AMF announced at the beginning of the year its intention to conduct briefer and more thematic “SPOT” inspections (*Supervision des Pratiques Opérationnelle et Thématique*), as well as its willingness to share the lessons learned from these exercises. Today it is publishing a summary of the SPOT inspections carried out in 2018 on the valuation of unlisted holdings by private equity management companies.

These inspections covered Articles L. 214-24-13, L. 214-24-14, L. 214-24-15, L. 214-24-16, L. 214-24-17, L. 533-10-1(2) and L. 533-22-2-1 of the Monetary and Financial Code, Articles 31, 33, 34, 35, 59(2), 61(1), 61(2)(a), 62, 67, 68, 69, 71(1) and 103 of Commission Delegated Regulation (EU) No. 231/2013, Articles 121-4 and 321-1 of Regulation No. 2014-01 of the *Autorité des Normes Comptables* (the French national accounting standards body), and Section 5 of the ethical regulations of asset management companies involved in private equity established by the AFG<sup>1</sup> and France Invest (former AFIC) relative to the transfer of holdings.

This summary does not constitute a policy element. It constitutes neither a position nor a recommendation.

### 1 SCOPE AND METHOD OF THE INSPECTIONS CARRIED OUT IN 2018

The SPOT inspections of the valuation of unlisted holdings carried out in 2018 are consistent with the previous inspections made by the AMF of asset management companies specialised in private equity. In those previous inspections, the AMF observed:

- (i) shortcomings in the valuation procedures, often too succinct and lacking in precision in terms of the methods employed, their prioritisation and their implementation methods;
- (ii) a lack of formal and traceable processes for valuating holdings during their lifetime, and in one case the absence of an update of the valuations (maintained at cost price for long periods with no justification);
- (iii) a second-level control defect in the valuation system.

These shortcomings made it impossible to ensure the relevance and consistency of the valuation methods used (consistency over time for the same valuation and consistency between various holdings). In addition, the lack of formalised processes both *a priori* and *a posteriori* failed to guarantee the prevention of arbitrariness risk in the valuation<sup>2</sup>.

The AMF also noted on several occasions that the transfer of holdings between vehicles was not subject to robust oversight (lack of relevant procedure, failure to call on the services of an independent expert and

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<sup>1</sup> Association Française de la Gestion Financière (french asset management association).

<sup>2</sup> The reader is advised to refer to the AMF Enforcement Committee Decisions No. 18 of 29 December 2017 and No. 14 of 17 November 2016.

assessment made following the sale).

In the light of these findings, the SPOT inspections conducted jointly at five asset management companies (AMCs) specialising in private equity and addressing professional clients, all of them authorised in respect of the AIFM Directive<sup>3</sup>, examined the following in particular:

- the organisation of the financial valuation system, notably as regards the degree of independence of the valuer (internal or external) relative to the management;
- the detailed and precise nature of the valuation procedure in place, its compliance with the rules of the ANC and IPEV and its ability to satisfactorily reduce the risk of arbitrariness in the application of valuation methods and prudential discounts;
- the consistency and adequate justification of the valuation, tested via a sample of four to five holdings valued by each AMC;
- the supervision of the sale price in transfers of holdings between two funds managed by the same AMC;
- the consistency between the exit price and previous valuations, , as well as the existence of potential cases of over-valuation;
- correct information for unit holders concerning the valuation of holdings in the funds;
- the internal control system in place for valuation processes.

The investigations concern the period from 1 January 2015 to 31 December 2017.

## 2 KEY FINDINGS FROM THE INSPECTIONS

### SUMMARY

#### Independence of the valuer

- All five of the AMCs inspected have implemented a **valuer function**. Three of them have opted for an internal valuer and two an external valuer. The function is supplemented at one AMC by a person specifically responsible for first-level controls of compliance with the procedure.
- For four of the AMCs inspected, no problems were identified concerning the independence of the valuer. However, for one of the AMCs, the independence of the valuer was not guaranteed for the inspection period, since the procedure specifies that it is the senior managers (who are also fund managers) who make the final decision on the valuation. Furthermore, the items provided are insufficient to determine the due diligence checks carried out by the valuer, **the reasons having led the valuer to approve the changes in methodology** observed, or the nature of the dialogue and any potential disagreements with the senior managers of the AMC.

#### **Review of the applicable regulation**

- Where the preparation of the valuation files is carried out initially by the holding directors (before review by the valuer), the independent valuer must trace all of the due diligence checks that he or she himself

<sup>3</sup> The AMCs in question are of varying size, with assets under management ranging from €0.1 billion to €2.5 billion.

has carried out, even if they are based in part on prior work by the fund managers<sup>4</sup>.

- The AMC, which is ultimately responsible for the establishment of net asset values, may choose to disregard (or “override”) the valuation proposed by the (internal or external) independent expert if the dialogue and any potential disagreements between the independent expert and the AMC are formally drafted and conserved, and the overrides are formally justified<sup>5</sup>.

#### The valuation system and the procedures involved:

- Of the five valuation procedures, four describe the valuation methods used (the fifth merely describing the main steps in the valuation process and omitting valuation methods). But only two prioritise said methods and determine in which case each method is to be used. In addition, the procedures lack precision as regards the practical manner in which the valuation methods are implemented.

#### **Review of the applicable regulation**

- AMCs must have a precise, detailed, operational and adapted valuation procedure that is as complete as possible<sup>6</sup>. The procedure:
  - must not simply inventory the valuation methods that may be used but specify in which cases each method will be privileged<sup>7</sup>, the aim being to reduce the risk of the use of discretionary valuation methods;
  - must also be as precise as possible concerning the practical manner in which these methods are implemented<sup>8</sup>. For example, the procedure must specify the criteria used to determine the discount level, indicate whether the valuer will use the average or median of the comparable multiples, provide the minimum size of the sample of comparables, and so on;
  - must describe the methods for valuing convertible bonds and, more broadly, all the types of assets held in the funds<sup>9</sup>.

#### Valuation of holdings transferred between portfolios:

- The inspection identified seven transfer operations in all, of which three cases of carry. The inspection did not detect any breach of the interests of unit holders but did reveal that the carry transactions were not subject to prior documentation.

#### **Reminder of the applicable regulation**

- Because transfers of holdings between portfolios intrinsically lead to a risk of conflicts of interest, they may not form a standard management practice for sales. They must be carried out in the interest both of the selling fund and the buying fund and according to adapted valuation conditions, as stipulated in the AMF Position-Recommendation No. 2012-11<sup>10</sup>. It is important that these transfers are supervised ahead of

<sup>4</sup> Article L. 214-24-15 and L. 214-24-17 of the Monetary and Financial Code and Article 67 of Commission Delegated Regulation (EU) 231/2013.

<sup>5</sup> Article L. 214-24-13 of the Monetary and Financial Code, articles 67(3) and 71 of Commission Delegated Regulation (EU) 231/2013.

<sup>6</sup> Article L. 214-24-14 of the Monetary and Financial Code, articles 59(2) and 67 of Commission Delegated Regulation (EU) 231/2013.

<sup>7</sup> Article 321-1 of Regulation 2014-01 of the Autorité des Normes Comptables.

<sup>8</sup> Article 68 of Commission Delegated Regulation (EU) 231/2013.

<sup>9</sup> Articles 67(1), Paragraph 2, and 69 (2) of Commission Delegated Regulation (EU) 231/2013.

<sup>10</sup> “Management companies must demonstrate particular vigilance where, as part of this liquidation process, they seek to transfer unlisted assets to other investment vehicles managed by themselves or an entity of their group. The management company must be in a position to demonstrate that the sale is in the interest both of the selling entity and the buying entity and that the sale is completed according to appropriate valuation conditions even where such sales fail to or are unlikely to attract a buyer on the market given the

time by specific rules in the procedural corpus of the AMC required to manage these conflicts of interest<sup>11</sup>. This last notably relies on the code of conduct of asset management companies operating in private equity as set out by the AFG and France Invest (ex AFIC), Section 5 of which states that calling on one or more independent experts or the concomitant sale of part of the assets concerned to a third party not in a conflict of interest is an “*indispensable minimum*” but “*shall not however be considered as ensuring that the valuation is consistent with the interest of the clients of the seller and the clients of the buyer*”.

- Prior to completion, any carry transaction must be suitably documented (for example, a carry agreement), notably stipulating the intention, reason, funds and holdings concerned, the number of securities, the compensation conditions involved, and the carry period, in order to prevent any ambiguity as concerns the valuation of the holdings concerned.<sup>12</sup>.

#### Good practice

- Seeking the advice of the investor committee (where such a committee exists) with a view to reducing the risk of conflicts of interest when transferring holdings between funds.

#### Informing investors about the valuation of holdings:

- The information addressed *a posteriori* to investors through periodic fund reports is comprehensive on the subject of valuation and in particular includes details on the valuation methods used. However, the information communicated *a priori* in the rules of the funds was insufficient for two of the AMCs as concerns the description of the valuation methods that may be used and the corresponding selection criteria.

#### Good practice

- Including in periodic fund management reports details on the valuation methods used and the assumptions selected for each line in the portfolio. When information is not provided in the periodic reports, referencing a description available elsewhere.

#### Justifying the valuation:

- The inspection tested the valuation processes for a sample of four or five holdings per AMC valued over six consecutive dates. This test identified **the overly partial nature of the entire set of audit trails provided**. Numerous explanations were found to be lacking as concerns the choice of valuation methods, the reasons for the choice of aggregates (multiples method), the nature of the valuer’s due diligence, the breakdown of the valuation by type of instrument, etc.

#### Reminder of the applicable regulation

- For each valuation of the holdings, a formal, exhaustive and self-sufficient audit trail must be established. The audit trail must explicitly shed light on the reasons for choosing the methods, updates to calculation methods (changes in parameters), the due diligence of the valuer, and the value of all the instruments making up the holding<sup>13</sup>.

*difficulty of determining in these conditions a sale price for these assets.”*

<sup>11</sup> Articles 31, 34 and 35 of Commission Delegated Regulation (EU) 231/2013.

<sup>12</sup> Article L. 533-10-1(2) of the Monetary and Financial Code, articles 67(1) and 71(1) of Commission Delegated Regulation (EU) 231/2013.

<sup>13</sup> Article L. 533-10-1(2) of the Monetary and Financial Code, articles 67(1), 69 and 71(1) of Commission Delegated Regulation (EU)

**Control system for the valuation of holdings:**

- The second-level controls of the valuation process are set out in the compliance and internal control plan of all the AMCs. However, it is **insufficiently documented for three of the AMCs**, with a lack of detail on the due diligence checks completed and the corresponding audit trail. For three of the five AMCs, internal audits are integrated in the second-level controls system. For the two others, the internal audits completed are consistent with the analyses made by the inspection.

**Reminder of the applicable regulation**

- It is essential to formally draft explicit and detailed control sheets for valuations, accompanied by supporting documents underlying the controls<sup>14</sup>.

**Good practice**

- Including in the internal control policy the lessons learned from AMF sanctions concerning private equity AMCs.

**2.1 INDEPENDENCE OF THE VALUER**

**Three of the five AMCs have an internal valuer.** The valuer is either a person or a committee of people independent from the fund managers. **Two of the five AMCs have outsourced the function.** In this respect, an agreement has been implemented between the AMC and the valuer. However, **this agreement does not specify the valuation methods to be used** by the external valuer as part of counter-valuations.

One of the AMCs has **supplemented its system with a valuation officer** in addition to the valuation committee. The role of this officer is to carry out first-level controls on the process of each half-yearly valuation operation. To **avoid any confusion** between the role of this officer and that of the internal valuer (played by the committee), this AMC was asked to clarify the specific responsibilities of each one in its procedure.

**For four of the AMCs inspected, no problems were identified concerning the independence of the valuer.**

However, **for one of the AMCs, the independence of the valuer relative to fund managers was not guaranteed a priori.** According to the procedure, the senior managers of the AMC, who are fund managers, are the ultimate decision-makers regarding valuation. Furthermore, the items provided are insufficient to determine the due diligence checks carried out by the external valuer, the reasons having led the valuer to approve the changes in methodology proposed by the management team, or the nature of the dialogue and any potential disagreements between the two parties. The AMC's justification was that, in practice, the valuation process was iterative and enabled the senior managers and the independent valuer to ultimately adopt a common position.

231/2013, Article 121-4 of Regulation No. 2014-01 of the Autorité des Normes Comptables.

<sup>14</sup> Article 61(2)(a) of Commission Delegated Regulation (EU) 231/2013.

### Review of the applicable regulation

- Where the preparation of the valuation files is carried out initially by the holding directors (before review by the valuer), the independent valuer must trace all of the due diligence checks that he or she himself has carried out, even if they are based in part on prior work by the managers.
- The AMC, which is ultimately responsible for the establishment of net asset values, may in theory choose to disregard (or “override”) the valuation proposed by the independent expert if the dialogue and any potential disagreements between the independent experts and the AMC are formally drafted and conserved, and the overrides are formally justified.

## 2.2 THE VALUATION SYSTEM AND THE PROCEDURES INVOLVED

The rudiments of the valuation systems of the five AMCs are relatively similar:

- initial valuation made on the basis of front-office data;
- review of initial valuations proposed by a member of the AMC’s executive committee (corporate secretary and/or CFO);
- presentation of all valuations (with accompanying justifications) at an internal valuation committee meeting;
- counter-valuation completed by the internal or external valuer;
- dialogue between the valuer and the committee to reach a consensus on a final valuation per reviewed holding;
- formal drafting of selected valuations;
- valuations sent to external accountant valuer;
- second-level / third-level control of the valuation process performed regularly by a professional with no operational involvement in the process.

The main differences between the AMCs notably lie in organisational details such as:

- the status of the valuer (internal or external, natural person or committee);
- the presence of a valuation officer at the AMC specifically tasked with (first-level) controls of compliance with the valuation process.

The five AMCs have introduced a specific valuation procedure. However, one of them is manifestly incomplete in that it provides a summary description of the various steps in the valuation process but no information on the valuation methods used. For the four other procedures, the most frequently cited valuation methods are as follows:

- price of recent investment;
- multiples;
- price envisioned as part of an exit process;
- discounted cash flows;
- net assets.

However, only two of these procedures indicate which methods are used as a priority and the criteria according to which the methods are chosen. In this respect, these two procedures specify that:

- post-acquisition, the price of the investment is used for 12 months;
- after which, the two AMCs make priority use of the method of trading multiples.

The other procedures simply list the methods, with no prioritisation and no selection criteria. As such, they give rise in practice to the possibility of an arbitrary choice.

The procedures are lacking in detail as regards the operational procedures involved in the implementation of valuation methods:

- as part of the method of trading multiples;
  - only one procedure specifies the minimum size of samples of comparable companies;
  - none of the five procedures indicates how to determine the multiples to be applied to the holding on the basis of multiples of comparable companies (for example, is it the average or the median that is used?);
- the procedures (apart from the procedure providing no information on valuation methods) advocate the application of an illiquidity discount, but only two of them specify the criteria used to determine the value of the discount to be applied;
- only one of the procedures stipulates the method for valuing convertible bonds. The procedures (apart from the one that provides no information on valuation methods) include information on the calculation of the enterprise value (EV) but not on the breakdown of this value by instrument.

#### Review of the applicable regulation

- AMCs must have a precise, detailed, operational and adapted valuation procedure that is as complete as possible. The procedure:
- must not simply inventory the valuation methods that may be used but specify in which cases each method will be privileged, the aim being to reduce the risk of the use of discretionary valuation methods;
  - must be precise in terms of the practical manner in which these methods are implemented. For example, the procedure must specify the criteria used to determine the discount level, indicate whether the valuer will use the average or median of the multiples of comparable companies, provide the minimum size of the sample of comparable companies, set criteria for determining the selection of comparable companies, and so on.
  - must describe the methods for valuing convertible bonds and, more broadly, all the types of assets held in the funds.

### 2.3 VALUATION OF HOLDINGS TRANSFERRED BETWEEN PORTFOLIOS

The risk of conflicts of interest involved in any transfers of holdings between two portfolios managed by the AMC is **addressed by two out of the five AMCs** in their body of procedures. In the case of transfers, the procedures of these two AMCs require that an expert be consulted as well as the approval of the investor committee.

Concerning the other three AMCs:

- for two of them, the rules of the managed funds address the risk of conflicts of interest involved in transfers of holdings but the operating procedure proposed does not include the necessity of calling on



- an independent expert;
- the third AMC has a complete description of the operating procedure but this last is formally documented for only a part of the rules.

Only two out of the five AMCs completed transfers (seven in all) in the period inspected:

- four of them (by a single AMC) were “classic” transfers for which the price was set on the basis of an expert report or the involvement of a third-party investor;
- three were carry transactions (made by two AMCs). The inspection revealed the insufficient formalisation of these carry transactions prior to their completion (description of the characteristics of the transaction, funds involved, carry period, etc.) and valuation conditions. But no breach was observed as concerns the interest of holders in that (1) the securities were sold at the acquisition price and (2) the carry period was limited.

#### Review of the applicable regulation

- Because transfers of holdings between portfolios intrinsically lead to a risk of conflicts of interest, they may not form a standard management practice for sales. They must be carried out in the interest both of the selling fund and the buying fund and according to adapted valuation conditions, as stipulated in the AMF Position-Recommendation No. 2012-11. It is important that these transfers are supervised ahead of time by specific rules in the procedural corpus of the AMC required to manage these conflicts of interest. This last notably relies on the code of conduct of asset management companies operating in private equity as set out by the AFG and AFIC, Section 5 of which states that calling on one or more independent experts or the concomitant sale of part of the assets concerned to a third party not in a conflict of interest is an “*indispensable minimum*” but “*shall not however be considered as ensuring that the valuation is consistent with the interest of the clients of the seller and the clients of the buyer*”.
- Prior to completion, any carry transaction must be suitably documented (for example, a carry agreement), notably stipulating the intention, reason, funds and holdings concerned, the number of securities, the compensation conditions involved, and the carry period, in order to prevent any ambiguity as concerns the valuation of the holdings concerned.

#### Good practice

- Seeking the formal approval of the investor committee (where such a committee exists) with a view to reducing the risk of conflicts of interest when transferring holdings between funds.

## 2.4 INFORMING INVESTORS ABOUT THE VALUATION OF HOLDINGS

For three of the five AMCs, the information received upstream by investors through the fund rules is adequate in that it refers to the IPEV rules, the concept of “fair value” and the available valuation methods. **The two other AMCs provide only partial information:**

- either it is not included in the rules for all the funds and does not specify the criteria used to select a method;
- or it does not provide information on the valuation methods used.

However, no shortcomings were detected in the information received *a posteriori* by investors through periodic fund reporting. These reports notably include details on the valuation methods used.

#### Good practice

- Including in periodic fund management reports details on the valuation methods used and the assumptions used for each line in the portfolio. When information is not provided in the periodic reports, referencing a description available elsewhere.

## 2.5 JUSTIFYING THE VALUATION OF HOLDINGS

For each AMC, the inspection included a test on the valuation of a sample of four to five holdings<sup>15</sup> at the end of each half year for the period from January 2015 to December 2017 (or six valuation dates). The aim of the test, covering a total of 144<sup>16</sup> valuations, was to:

- ensure that the valuation at each date was justified in writing;
- check that the valuation choices were compliant with the procedure and the principles of the IPEV guidelines;
- verify that the AMC correctly respected the principle of consistent methods, except in duly justified cases.

The test served to verify that all the holdings of the panel valued the holdings at their fair value. The use of the acquisition price was limited to recent transactions. To calculate this fair value, the most commonly used valuation method was trading multiples. This method is used frequently by all the companies in the panel, apart from one AMC, which uses the acquisition multiple, possibly revised upwards or downwards<sup>17</sup>. More specifically, the companies in the panel use the EBITDA multiple exclusively, apart from one AMC that uses several indicators (EV/EBITDA as well as EV<sup>18</sup>/Sales, EV/EBIT, PCF<sup>19</sup> or PER), which may differ according to the characteristics of the holdings. Using the EV/EBIT, PER or PCF in addition to the EV/EBITDA and EV/Sales takes account of the fact that comparable companies do not necessarily have the same financial structure or margin structure<sup>20</sup>.

In contrast, none of the AMCs used the DCF.

Three of the companies in the panel valued one or more holdings on the basis of the estimated sale price as part of an exit process under way. This approach is not provided for in the procedures of one of the three AMCs in question.

<sup>15</sup> Four holdings tested for one AMC, five for each of the other four

<sup>16</sup> In other words, (6 x 4) + (6 x 5 x 4) valuations

<sup>17</sup> For example, if a holding is acquired by the fund for 8x its EBITDA, it will continue during its lifetime to be valued at around 8x its actualised EBITDA.

<sup>18</sup> Enterprise value.

<sup>19</sup> Price to cash-flow.

<sup>20</sup> For example, two comparable companies may have a similar EBITDA but a substantially different amount of fixed assets (which will be reflected in amortisation and thus in EBITDA). They may also have a different level of debt (and thus financial charges), reflected in net income.

As part of this test, **none of the AMCs transmitted a complete audit trail** to the inspection team to enable an understanding and the justification of the valuation steps and confirm the compliance of these last with the procedures provided (notably minutes and support from the valuation committee, valuation sheet, comps tables, and a valuer summary). Numerous explanations are lacking as regards:

- the choice of valuation methods among the various possible methods (trading multiples, DCF, etc.);
- the choice of aggregates (EBITDA, EBIT, net income, etc.) as part of the multiples method;
- the justification of the selected discount level;
- the justification of parameter changes over time. For example, changes to the sample of comparable companies or the factoring in on an alternating basis of the average or median of multiples of comparable companies (with the use of the median preferable in theory as it eliminates the bias generated by any extreme values);
- the justification of the implementation of methods or adjustments not provided for in the procedure;
- the breakdown of the valuation by type of instrument.

#### Reminder of the applicable regulation

**➤** For each valuation of the holdings, a formal, exhaustive and self-sufficient audit trail must be established. The audit trail must explicitly shed light on the reasons for choosing the methods, updates to calculation methods (changes in parameters), the due diligence of the valuer, and the value of all the instruments making up the holding.

## 2.6 BACK-TESTING THE SALES OF HOLDINGS SINCE 2015

**Fifty-five holdings were sold** over the inspection period, 60% of them by a single AMC. To detect any cases of over-valuation, the inspection compared the sale price of the disposed holdings with the last two half-yearly valuations calculated.

This analysis did **not reveal any cases of over-valuation**. The negative differences observed between the last two valuations and the sale price are limited and of a modest level (less than 6% for the most recent valuation).

In contrast, the inspection identified that most of the sales were made for amounts considerably higher than the last two valuations calculated. While major differences were observed between the penultimate valuation and the sale price for four of the AMCs, a sharp correction in the differences was observed on the last valuation.

## 2.7 CONTROL SYSTEM FOR THE VALUATION OF HOLDINGS

Three of the five AMCs have a compliance and internal control officer. The two others have outsourced this function (to a law firm or consultancy).

### Annual Control Plan

**For four out of the five AMCs**, the control of the valuation process was provided for in the annual control plan

for the period reviewed by the inspection.

However, for one of the AMCs, this process was removed from the plan in 2017 following the transfer of responsibility for this control from the compliance and internal control officer to the valuation officer. This transfer is consistent with the valuation procedure, which specifies that the role of the valuation officer is to verify the correct application of the valuation procedure after each valuation committee meeting on the basis of this committee's report. Nevertheless, **this transfer is tantamount to eliminating the second-level control of the valuation process**, since the valuation officer systematically involved in the operational process carries out the first-level control. Moreover, **the work of the valuation officer in 2017 was not formally documented**. This is why the inspection team asked the AMC in question to supplement its approach with a review by the compliance and internal control officer of the valuation process, which the AMC approved.

#### Second-level controls

The formal documentation of second-level controls of the valuation process is satisfactory for two out of the five AMCs. It was insufficient for the three others for the following reasons:

- **for one AMC**, the valuation control sheet consists of a checklist solely targeting the existence of a visa for valuation media. It includes **no formalised analysis of the assessment of the holdings**. In addition, the compliance and internal control officer's work file consists of handwritten notes that are difficult to use;
- **for another AMC**, the half-yearly control sheets provided **do not give a precise idea of the due diligence performed**. The conclusion of the control is not backed up by a solid audit trail (no supplement to this trail having been supplied despite the request of the inspection team);
- **for the last AMC**, the control sheets are well structured **but contain no information on the volume or nature of the holdings tested**. The compliance and internal control officer acknowledged the interest of being more precise on this point in the formal documentation of future work.

Furthermore, **for one of the AMCs**, the inspection noted the best practice consisting in **taking account, via a recommendation by the compliance and internal control officer, of the sanction issued by the AMF to an AMC on 29 December 2017**. A recommendation was issued by the internal control department of the AMC requesting that the following be taken into account in the valuation procedure:

- measures ensuring the independence of the external assessment;
- conditions on changes to the assessment methods for assets;
- the process for re-examining the value of assets where a substantial risk of incorrect valuation exists.

#### Internal audit

In organisational terms, **three of the five AMCs do not have an internal audit function**, which is understandable given their size and business activity. For two of these three AMCs, the internal audit is conflated with the second-level controls performed by an external provider.

**For one of the three AMCs, the valuation process is adequately covered by the third-level control**. Two internal audit reports issuing from the 2014-2015 audit plan were provided to the inspection team. Containing satisfactory detail on the due diligence performed, these reports address controls of:

- the approval of the valuation calculation by the portfolio management head;

- the independent control of this calculation by the valuation committee and the internal valuer;
- the permanent nature of methods used to calculate the impairment of the assets.

The audit plan also provides for two audits of the valuation process in 2019 and 2020.

**For the last AMC**, an audit of the valuation of holdings was carried out in 2017 by an external firm. **Similar to the inspection**, this recent audit observed a lack of traceability concerning the valuations selected and an insufficient justification of the discount levels.

#### Annual reports on internal control

**For two of the five AMCs**, these reports adequately covered the due diligence checks of the valuation process for the three-year period addressed by the inspection. However, for two of the other AMCs, these controls were insufficiently reported or not documented.

The remaining AMC did not provide an annual report on internal control to the inspection team, but instead the minutes of the quarterly risk committee meetings covering all of the company's strategies. These meetings notably address the valuation process and bring together the compliance and risk management teams under the chairmanship of a deputy CEO of the AMC. The report of the Q2 2016 committee meeting stressed the absence of a valuation policy and an independent valuer (these points having since been resolved).

#### **Reminder of the applicable regulation**

- It is essential to formally draft explicit and detailed control sheets for valuations, accompanied by supporting documents underlying the controls.

#### **Good practice**

- Including in the internal control policy the lessons learned from AMF sanctions concerning private equity AMCs.

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#### **Changes**

- The AMF Position-Recommendation No. 2012-19 will be supplemented in 2019 to include the reminders included in this summary.