



NAV Calculation Error - the Legal Guidelines & Actions Taken

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January 2020

In my capacity as director of LFP I SICAV, a Luxembourg umbrella fund subjected to widescale fraud and service provider failures, I investigated and discovered major investor misrepresentations of share valuations or “NAV’s”.

All four discrete sub-funds were subjected to NAV Calculation Error issues. In each case, these were reported to the local regulator, the CSSF, under the CSSF circular 02/77 guidelines, and as a result impacted the status of investors, who de facto become unsecured creditors in these sub-funds, and thus no longer shareholders.

While each regulatory jurisdiction operates in different ways, the matter of subscription and redemption of shares at the prevailing NAV per share is governed by two issues :- magnitude, and intent. A Calculation Error can arise for many reasons - equalisation calculation errors are the most common in bona fide cases, since the fund administrator prepares the NAV, and the investment manager and/or fund directors have to approve and sign off the calculations, so there is a 2-step verification process to screen out errors. Actions taken upon such NAV Calculation Error are dependent on the magnitude of the error as a percentage of the underlying NAV, with a 5% threshold usually accepted as triggering various actions for illiquid investments, and 1% being the threshold in UCITS or very liquid funds.

That said, there are cases where valuations are falsified, particularly where the fund administrator may lack the investment “class of asset” expertise, and/or the independence of asset valuation is compromised. An NAV Calculation Error action then rests with the investors, as contract law and fraud/misrepresentation become the governing factors determining the legal steps available. From a legal basis, the investment is rendered null and void and the investors would be returned their money. **If the NAV was overstated and the investors believe the re-calculated NAV to be an advantageous entry level, they can, with board of director approval, request that their investment subscription be processed at the newly calculated NAV***. However, to do so automatically would waive all rights should further NAV Calculation Errors come to light governing the particular subscription date in question, so investors should proceed carefully and warily.

In the case of investor redemptions, an overpayment of redemption proceeds is a complicated affair. Firstly the investor should theoretically re-imburse the fund, but with nominee shareholdings etc.. this is often hard to enact, as well as most investors being reluctant to return any such monies, especially if some time has elapsed before any such clawback is requested. If investor re-imbursement proves difficult/impossible, then the directors would look to the fund administrator and/or the investment manager, ie those empowered to sign off the miscalculated NAV, to re-imburse the fund for any such losses arising from overpayment of redemption proceeds. As a corollary, in the case of an underpayment of redemption proceeds, the fund would simply reimburse the redeeming shareholders the appropriate additional amount.

A general matrix can be used, for **new subscriptions** :

	UCITS / Liquid Funds - Error Magnitude		Illiquid Funds - Error Magnitude	
	< 1%	> 1%	< 5%	> 5%
Bona Fide Error	Re-process share issuance with board approval	Re-process share issuance with investor approval	Re-process share issuance with investor approval	Re-process share issuance with investor approval
Deliberate Error *	Nullify Subscription	Nullify Subscription	Nullify Subscription	Nullify Subscription

* Re-process share issuance with director approval and investor approval, if requested.

And for **share redemptions** :

	UCITS / Liquid Funds - Error Magnitude		Illiquid Funds - Error Magnitude	
	< 1%	> 1%	< 5%	> 5%
Bona Fide Error	Absorb loss with board approval if overpayment made. Re-imburse in case of underpayment.	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.
Deliberate Error *	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.	Recover any overpayment if possible, otherwise a cost to NAV sign-off authorities. Re-imburse in case of underpayment.

The above matrices are general industry-accepted guidelines, with the threshold per jurisdiction often written into local fund regulations.

References :-

- 1). www.cssf.lu/en/Document/circular-cssf-02-77/
- 2). www.sec.gov/divisions/investment/icvaluation
- 3). www.investmentexecutive.com/news/from-the-regulators/ific-releases-guidelines-for-correcting-portfolio-nav-errors/

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