Fair Value Pricing Survey, Eleventh Edition
Finding the formula that fits
Contents

Executive summary 1

Key findings 6

Conclusion 7

Contacts 8
Executive summary

It goes without saying that there is no precise formula for determining fair value and performing related oversight. Those charged with valuation responsibilities have to do what any scientist in a lab would do: pursue a course of action, measure the results, and then refine the approach, taking into account changes in internal and external factors. Over the eleven years that we have conducted our annual Fair Value Pricing Survey, we have seen mutual fund firms continue to tweak their valuation efforts in search of the right formula. Along the way, we have cataloged both emerging practices and those that have matured into common industry processes.

Morgan Keegan settlement returns the spotlight to valuation oversight

The omnipresent threat of regulatory action has long hovered over the valuation process — a threat that became real this past year, when one board’s oversight formula was publicly challenged. In June, the former mutual fund directors of the Morgan Keegan Funds settled administrative charges brought by the U.S. Securities and Exchange Commission (SEC) regarding their oversight of pricing procedures. This case, which came after a series of other SEC enforcement actions, was more than a warning shot — it was the strongest signal yet that the SEC has fund directors firmly in its sights, holding them responsible for fair valuation decisions.

Against the backdrop of the Morgan Keegan case, this year’s survey garnered the highest participation since we launched it in 2001: a record 96 mutual fund firms representing more than $10 trillion in assets under management completed the survey.

SEC enforcement actions have mutual funds stepping up their focus on fair value.

A strong indication of how seriously fund boards are treating valuation issues after the case was evident from the fact that survey participants identified SEC enforcement actions as the most talked about valuation topic among board members outside of regularly scheduled meetings. These discussions, as well as deliberations during regular board meetings gave directors opportunities to assess whether they needed to change elements, such as the timing and frequency of their oversight, the type and extent of materials being reviewed, and the level of delegation provided to others. These efforts bore fruit as this year’s survey shows that changes have been made to valuation oversight practices.
Finding the right balance of information can require experimentation. Providing too much detail may create difficulties for board members in identifying salient points or relationships that may be obscured by the volume of data. Providing too little detail, on the other hand, may result in board members not being able to identify the key questions they should be asking. Whether fund boards decide to make changes to their oversight approach is, in the end, a matter of judgment. That judgment will likely be directly affected by the types of funds and the nature of investments they oversee, perceived valuation risks, and external factors that impact fair value decisions.

Apart from SEC enforcement actions, 34 percent of survey respondents identified trading halts as the second most popular subject prompting discussion among directors outside of regular meetings. Trading disruptions can affect the availability of security prices, and, as a consequence, can trigger the need for fair value determinations, particularly when trading halts extend past the time for fund net asset value (NAV) calculations. As technology glitches continue to plague securities exchanges, it appears likely that these issues will continue to demand attention from fund directors and management alike.

### Table: Types of valuation materials provided to the board

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Back-testing results on foreign equities priced using a standardized fair value process</td>
<td>86%</td>
</tr>
<tr>
<td>Written valuation memo regarding fair value decisions</td>
<td>84%</td>
</tr>
<tr>
<td>Information on the valuation controls</td>
<td>81%</td>
</tr>
<tr>
<td>Analysis of impact on NAV of individual fair value decisions</td>
<td>64%</td>
</tr>
<tr>
<td>Information on the valuation disclosures and procedures for financial reporting purposes</td>
<td>64%</td>
</tr>
<tr>
<td>Fair value price compared to actual sale price upon disposition</td>
<td>57%</td>
</tr>
<tr>
<td>Calculations supporting fair value decisions</td>
<td>53%</td>
</tr>
<tr>
<td>Prices for illiquid/thinly traded securities</td>
<td>53%</td>
</tr>
<tr>
<td>Value of each fair-valued position as a percentage of total investments</td>
<td>52%</td>
</tr>
</tbody>
</table>
Balancing risk with efficiency

The survey findings show that risk management remains an integral part of the valuation alchemy for many fund groups. More than half — 51 percent — of survey participants indicated that they had identified valuation risks for one or more specific investment types as part of their annual compliance reviews under rule 38a-1 or formal risk assessment process.

Almost six out of seven respondents (84 percent) reported that their fund’s chief compliance officer (CCO) has a full-time presence at board meetings when valuation matters were discussed. CCOs were also more actively involved in identifying risks associated with the valuation of investment classes. Additionally, 58 percent of respondents noted that adviser compliance personnel also have full-time participation at such meetings.

There is also an indication that some fund groups adjust the timing, nature, and extent of their processes and internal controls based on the type of investment or macroeconomic data. For example, certain funds identify investment valuations requiring further scrutiny by customizing their procedures based on the presence of market-related events, such as movements in an underlying benchmark or changes in credit quality. This approach can be an efficient way to increase effectiveness because it allows fund groups to focus on instances that may be more susceptible to valuation risk, rather than relying on standardized triggers that apply broadly across the asset class.

Given the current business and regulatory environment, a thoughtful assessment of valuation risks allows fund groups to balance both effectiveness and efficiency. In this regard, 38 percent of survey participants indicated that they had conducted an analysis in the last year designed to identify ways to improve the efficiency of the valuation process and to reduce redundancies. More than 60 percent of these same survey participants increased automation in their valuation processes in the current year, suggesting there may indeed be a way to rethink the formula for processes and controls to generate better results overall.
Looking ahead
We asked our survey participants to identify what they believe will be the most pressing valuation challenges over the next one to two years. Not surprisingly, navigating future actions, guidance, and expectations of the SEC was at the top of the list for many survey participants. There was a wide range of responses, but the most common are grouped below into these five main areas:

Changes necessitated by SEC regulatory action
Challenges in the regulatory arena include the uncertainties associated with the SEC’s next action, including what it will say (e.g., how prescriptive its guidance or admonitions may be) and how it will say it (e.g., in an SEC speech, another enforcement action, or more formally through proposed industry-wide guidance). Given the complexities associated with valuations and the different practices followed within the industry, it will be important for the industry to continue to share its experiences and perspective in advance of any final SEC action.

Pricing vendor oversight
Pricing vendors continue to offer new asset class valuation products, as well as new tools to assist the industry in fulfilling its valuation responsibilities. This year, survey responses revealed an increased focus on transparency tools and how best to use them. These transparency tools can provide meaningful assistance to fund groups in determining whether to make price challenges, as well as aid in the overall understanding and assessment of a pricing vendor. With these potential benefits also come challenges, such as evaluating how frequently and formally to employ such tools and what steps funds may take in the valuation process when presented with contradictory evidence to the primary valuation.

Managing the external audit process
It can be difficult for fund groups to understand current external audit requirements and expectations for valuation testing. Gaining a full understanding of the external auditor’s procedures is important, as well as being flexible enough to handle new audit requests arising because of changing requirements and expectations. Fund boards also need to ensure that they understand the benefits and limitations of the external audit in connection with their valuation responsibilities.
Finding the right formula to address these and other challenges will require further exploration in the years ahead. The key will be anticipating and planning for future challenges, including building an infrastructure that is adaptable and flexible enough to address developments as they unfold.
Other survey highlights
We have summarized below certain noteworthy survey results for three subject areas: policies and procedures, pricing sources, and specific investment type fair value considerations.

Policies and procedures
• Approximately 61 percent of survey participants indicated that the front office is responsible for notifying fund accounting or management if it becomes aware of any market or issuer-specific events that may affect pricing.

Pricing sources
• Consistent with last year’s survey, the majority of survey participants (82 percent, compared to 79 percent in the last year) indicated that they use different pricing vendors depending on the asset class.
• Fifty-five percent of survey participants pursue price challenges on both primary pricing sources and secondary pricing sources, with the remaining 45 percent only doing so for primary sources.
• Fifty-three percent of survey participants have a formal process in place specifying what to do when a pricing vendor reaffirms a price after the submission of a challenge.

Fair value considerations for specific investment types
Equities
• Eighty percent of survey participants compare each day equity prices received from the primary pricing source to a secondary source, compared to 77 percent last year, and 61 percent two years ago.
• The S&P 500 Index (either directly or through the use of S&P 500 futures contracts) remains the most common proxy used to identify situations in which the closing price for equities trading on foreign exchanges may require adjustment.

Fixed income
• Greater than 60 percent of survey participants use bid pricing exclusively, compared to 51 percent last year.
• Depending on the asset class, between 30 and 36 percent of survey participants indicated that they compare daily fixed income prices received from their primary pricing source to a secondary source, whereas less than 30 percent of survey participants reported doing so last year.
• Seventy percent of daily pricing validation checks (e.g., day-over-day comparisons and back testing) are performed prior to the 4:00 p.m. NAV strike.

Derivative contracts
• Eighty and 82 percent of survey participants determine valuations for interest rate swaps and credit default swaps, respectively, based primarily on prices obtained from a pricing vendor.

Restricted securities
• Fifty-five percent of survey participants use a discount of five percent or less from the price of the registered issue of the same or similar security when the restriction on a security is three months or less.
This year’s survey illuminates once more that valuation practices and processes are continually being refined in ways large and small. After all, valuation is an ongoing and iterative process — even when a fund finds the formula that fits, its investment setting and other factors can and often do change. Over the years, we have seen our survey respondents adjust to these changes, and we suspect that they will continue, particularly as the SEC steps up its focus.

**Background**

Deloitte’s eleventh annual Fair Value Pricing Survey aggregates the views of 96 mutual fund firms and respondents hold more than $10 trillion in assets under management. The population of survey participants represents a diverse mix of mutual fund firms encompassing various sizes, asset classes, and geographies. The survey took place between June and August 2013.
Contacts

Industry leadership
Cary Stier
Vice Chairman
U.S. Investment Management Leader
Deloitte LLP
+1 212 436 7371
cstier@deloitte.com

Elizabeth Krentzman
U.S. Mutual Fund Leader
Deloitte & Touche LLP
+1 202 370 2320
ekrentzman@deloitte.com

Rajan Chari
Partner
Deloitte & Touche LLP
+1 312 486 4845
rchari@deloitte.com

Paul Kraft
Partner
Deloitte & Touche LLP
+1 617 437 2175
pkraft@deloitte.com

Tyson May
Partner
Deloitte & Touche LLP
+1 312 486 1890
tmay@deloitte.com

Alexey Surkov
Partner
Deloitte & Touche LLP
+1 212 436 3698
asurkov@deloitte.com

Acknowledgements
We would also like to thank Brian Gallagher, Rob Fabio, and the many others who contributed to the preparation of this survey.