



# Fair value pricing survey, twelfth edition

## Positioning for the future

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In the aftermath of the enforcement action against an investment company's Board of Directors and related settlement, the mutual fund industry enjoyed a comparatively quiet year on the valuation front without any formal valuation guidance issued by the U.S. Securities and Exchange Commission (SEC). The lone exception came as our survey was closing in July, when the Money Market Fund Rule (the Money Rule)<sup>1</sup> referenced several aspects of valuation and fund governance.

<sup>1</sup> <http://www.sec.gov/rules/final/2014/33-9616.pdf>



Up until then, the relative calm had as much to do with the market's persistent rise as it did to the lack of SEC activity or another high-profile enforcement case. The Standard & Poor's 500 Index ended 2013 up 30% , and it has enjoyed mostly smooth sailing again this year. Fixed income markets have participated in the rally as well, owing to supportive easy-money policies enacted by global central banks. Perhaps the best gauge of the current even-keel environment rests in the Chicago Board Options Exchange Market's Volatility Index — or the "VIX" — which has remained extremely muted by historical standards.

Also, the kinds of "black swan" events that created valuation challenges in recent years, such as the Japanese typhoon or U.S. debt downgrade that roiled the markets, have mercifully dissipated. To be sure, there was no lack of headlines over the past 12 months, as the geopolitical landscape was rife with potential macro-economic landmines such as the turmoil in Ukraine, the emergence of ISIS in Iraq and Syria, and the economic slowdown in Europe. But, nearly without fail, the markets shrugged off these developments in the main, sending assets to record heights.

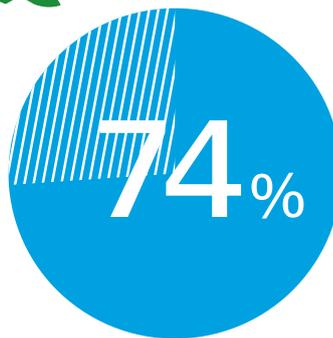
Nonetheless, no one would argue that the valuation process has become any easier. The responsibility of mutual fund groups to determine what they believe best reflects fair value for every investment has not changed, and the fundamental responsibilities of their Boards relative to valuation have likewise not lessened. What is different is the increased availability and interest in market data, transparency tools, automation and technological solutions, all of which allow mutual fund groups to do more in the same or perhaps even less time than before, resulting in more compelling analytics and data to support their decisions.

Against this backdrop, 92 mutual fund groups participated in our twelfth Fair Value Pricing Survey. The findings demonstrate that fair valuation remains a "top of mind" issue for investment managers, Boards and their stakeholders. To no surprise, change was the "name of the game" as 74% of the survey participants indicated that they had revised their valuation policies and procedures over the last year, finding opportunity to evaluate and enhance their valuation processes. The most common changes related to the addition of specific procedures for certain investment types, changes to pricing sources and enhancing language or details for



## Mutual fund groups

participated in our twelfth Fair Value Pricing Survey



## Survey participants

indicated that they had revised their valuation policies and procedures over the last year

certain hard-to-value investments. The percentage of mutual fund groups using a zero trigger in fair valuing foreign equities continued to grow as well, reaching nearly 50%, the highest level attained since we started the survey. Other survey participants continue to use the key valuation indicators, S&P 500 and/or Russell 1000, combined with thresholds, i.e., 50 basis points, to identify whether to make an adjustment to the closing exchange price of their foreign equity holdings.

### Board governance

The SEC surprised many people this year by issuing valuation guidance in July; only 5% of those participating in the survey actually expected the SEC to make such a move in 2014. What was surprising about the guidance was not only that it was issued at all, but also where it was housed, within the Money Rule. We all anticipated that the SEC would speak about the need to fair value money market fund holdings instead of using amortised cost, and it was anticipated that there would be some guidance suggesting how often shadow pricing should be performed. However, the SEC's comments on what non-money market funds using amortised costs for securities (with 60 days or less until maturity) were expected to consider each day was not anticipated, nor was the re-emphasis of the role of the board in considering how pricing vendors value investments.

Before then, the most recent SEC activity directed at boards was the enforcement action that settled in 2013. With that development as context, the 2014 survey asked questions designed to assess whether Boards had made changes to their oversight activities, and we noted the largest changes in the following areas:

- 40% of survey participants said they have changed the types of valuation materials provided to the Board, compared to 54% a year earlier.
- 39% of survey participants have changed the level of detail in the valuation materials provided to the Board, compared to 57% a year ago.

Knowing exactly what to receive and when to receive it is not always easy, as some materials are probably not necessary in all circumstances. One of the emerging trends in this year's survey was that 9% of survey participants indicated that the Board added valuation risk dashboards or key valuation indicators (KVIs) over the last year to assist in their oversight of the valuation process. Given the judgment required in knowing what reports are needed, and the regulatory guidance around the need for "continuous monitoring," we can envision Boards using tools like these more often in the future as a risk-intelligent way to determine when the environment has changed, when the level of price uncertainty is higher for a particular asset class, when Boards might want to increase their level of involvement, and what information they will need to receive to effectively do so.



### Use of market data

The price challenge process has long been an area of discussion in our surveys as it is a highly judgmental area and one where potential conflicts of interest often can arise. The process also calls for strong controls to ensure that management bias does not play into the valuation process. Mutual fund groups have long debated and executed price challenges based on market data and secondary vendor price comparisons, as well as news and events specific to the market, industry, and issuer.

However, there is little debate that a well-supported price challenge should include such market data. This allows the evaluated pricing provider to challenge its valuation process and determine whether relevant market data was considered as part of its evaluated price determination. Survey participants seem to agree, as 54% indicated that they challenge a price only when they have conflicting market data that would suggest the price is not accurate. This response seems to be aligned with the emergence of pricing transparency tools that enable mutual fund groups to study the inputs and market data behind an evaluated price.

In addition, there has been plenty of discussion as to the appropriate amount of documentation required of an affirmed price challenge by the pricing vendor. To this end, 41% responded that they document the nature of the pricing challenge and note that the pricing vendor affirmed its evaluation, and 43% answered that, upon receiving an affirmation, they reach back out to the initiating source, discuss the results of the challenge and conclude thereafter.

Finally, similar to the prior year's survey, 73% indicated that they may change the price if they feel it is inaccurate even if they do not hear back from the pricing vendor. This supports the use of market data as a trend, at least as far as the data helps mutual fund groups go beyond the pricing challenge process and contest the need for certain secondary source comparisons. It is also supporting determinations regarding the risk associated with valuations where little market data exists to support the underlying evaluation.



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## Investment managers and Boards took the opportunity to continue to evaluate and enhance their valuation process

### Valuation risk management

The formalisation of risk oversight continues to be a maturing trend, with 59% of the fund groups indicating that they now have a risk function. Also, as noted in prior surveys, valuation as an enterprise risk has continued to take root. In this year's survey, 48% of mutual fund groups identified risks associated with the valuation of certain investment types as part of their formal Rule 38A-1 or enterprise risk assessment process, compared to 51% in the previous year. Overwhelmingly, 95% of those survey participants have identified internal controls to manage the valuation risk, and 57% have identified valuation of portfolio investments within the risk charter and the related price challenge process as a valuation risk.

With valuation risk increasingly on funds' radar screens, KVIs may have broader potential applications than just in the board room, as management can use them to help determine where the greatest risks exist and on

which asset classes to focus precious time and effort. Ultimately, KVIs help identify when potential risks surface as real issues, and, in their ideal state, can highlight potential risk areas before they lead to a "code red" event.

Therefore, risk-based tools in the valuation process may be an upcoming trend. One notable finding is the 20% of survey participants who had developed risk management assessments such as asset and stress test liquidity tests, consistent with the SEC's January 2014 guidance (No. 2014-1)<sup>2</sup>, and used the results as part of their valuation process.

<sup>2</sup> <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>

### Looking ahead

Whether more risk-based metrics and tools will be incorporated into the valuation process in the future is yet to be seen, but we do know that regulatory risk has prompted perennial change for the industry when it comes to valuation issues. In the year to come, certain matters on the regulatory front bear monitoring:



#### Pricing vendor oversight

The SEC's comments in the Money Rule relating to Board consideration of pricing vendors may result in increased Board activities in this area or the development of greater linkages to how the Board performs its required duties. The guidance may also create an increased focus on evaluating whether or not prices of securities for both domestic and foreign investments (not just equities) are as of 4 p.m. EST, as the SEC specifically noted that Boards should consider how close the price is determined to the time that the mutual fund calculates its NAV per share.



#### Short-term debt valuation

The Money Rule also emphasised the need for fund management to ensure that it takes measures to assess whether amortised cost approximates fair value each day that it uses such a measure to value a security, even for non-money market funds. This may spawn more concrete procedures and documentation to demonstrate such, or, alternately, result in a movement away from amortised cost for such investments.



#### Alternatives sweep exams

During the year, the SEC's Office of Compliance, Inspections and Examinations conducted sweep exams focused on the use of alternative investments (e.g., derivatives, leverage) in the mutual fund industry. Clearly, the findings from these sweep exams could put added expectations on mutual fund groups and Boards to continue to elevate the bar for valuation processes.



#### Private equity valuation

Some mutual funds hold a small portion of their assets in private equity investments or other investments that are illiquid, and valuation can often be challenging because it requires considerable judgment coupled with a lack of public information. The SEC's examination of private equity fund managers led to comments in various articles and speeches over the past year regarding the valuation of private equity investments, such as the following remarks made at a forum in 2014<sup>3</sup>:

*"Some of you may be under the mistaken impression that when our exams focus on valuation, our aim is to second-guess your assessment of the value of the portfolio companies that your funds own ... to challenge that a portfolio company is not worth X, but X minus 3%. We are not, except in instances where the adviser's valuation is clearly erroneous.*

*Rather, our aim and our exams are much more focused. Because investors and their consultants and attorneys are relying on the valuation methodology that an adviser promises to employ, OCIE examiners are scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors. Some things our examiners are watching out for are:*

- *Cherry-picking comparable or adding back inappropriate items to EBITDA — especially costs that are recurring and persist even after a strategic sale — if there are not rational reasons for the changes and/or if there are not sufficient disclosures to alert investors.*
- *Changing the valuation methodology from period to period without additional disclosure — even if such actions fit into a broadly defined valuation policy — unless there's a logical purpose for the change."*

3 <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361>

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## The survey results continue to show that mutual fund groups are making changes in how they use data in their valuation process

Although these comments were clearly directed at the private equity fund industry, it is possible that the SEC could apply them to those mutual funds holding private investments with valuations significant enough to affect the NAV per share of the fund. Such an outcome could lead to the need to evaluate the current disclosures in the prospectus and in shareholder reports.

Regulatory risk is not the only driver of potential change. In an environment where more data continues to become available, the ability to do more with it in less time is emerging as a differentiating strategy. The survey results continue to show that mutual fund groups are making changes in how they use data in their valuation process, as approximately 50% of survey participants either increased automation in the valuation process over the past year and/or conducted a study designed to find efficiencies in the valuation process. This finding is significant in that it shows mutual fund groups realise the need to continue to evolve so they can become more nimble. Finding a way to do so which still being risk conscious may be a difficult but important challenge.

All of us know that being able to understand the risks present when a crisis hits, as well as the exposure to them, is a critical capability for weathering the storm as

quickly and efficiently as possible. Six years may seem like yesterday, but that is exactly how long it has been since the credit crisis of 2008, and no one has forgotten how difficult valuations were to assess during that time.

While the fact that the last two significant economic downturns have occurred within about six years of each other does not necessarily mean another downturn is around the corner, it does serve to remind us of the importance of being prepared — taking care to evaluate the inputs in the valuation process and determining which ones might be most subject to volatility in a troubled market; revitalizing due diligence on brokers that may be able to supply prices on valuations where needed; revising internal controls relating to manual processes; and strategically making use of the technology available to assist in the valuation process.

Most importantly, fund groups need to always have one eye on the rear view mirror and consider the valuation lessons learned from 2008 and other circumstances marked by limited liquidity and market data. Valuation during times of relative calm is complex enough. When conditions are less than ideal and hidden risks may surface, being prepared is the best antidote.

### To the point:

- Findings demonstrate that fair valuation remains a “top of mind” issue for investment managers, Boards and their stakeholders
- Change was the “name of the game” as 74% of the survey participants indicated that they had revised their valuation policies and procedures in the last year
- Governance, use of market data and risk were at the top of the agenda for survey participants