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Fair Valuation Pricing Survey Fourteenth Edition

Governance and valuation teams take the momentum of liquidity and business continuity issues in stride

Investment Management
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Executive Summary

Governance and valuation teams take the momentum of liquidity and business continuity issues in stride

Expect the unexpected. It sounds hard to do, and it is. It would have been difficult, for example, to predict that trading on the New York Stock Exchange ("NYSE") would halt as it did in July 2015. Likewise, the outcome of the "Brexit" vote in the United Kingdom in June 2016 was hardly "expected," at least by most market watchers.

Nonetheless, it is important for the management of fund groups to learn how valuations are affected by crises and other unexpected events. As the summary results of the 14th edition of the Deloitte Fair Valuation Pricing Survey (the "FV Survey") indicate, fund groups are taking this charge seriously, building on momentum they have established in recent years. This momentum includes developing robust valuation policies and procedures and advanced valuation techniques and tools.

Of course, each year brings unique challenges. This year, attention is focused intently on the issues of liquidity and the involvement of service providers in response to regulatory comments, such as those made by SEC Chair Mary Jo White in her May 2016 keynote address at the Investment Company Institute's (ICI's) 2016 General Membership Meeting.

> "Increasingly, funds have acquired portfolio investments that make it difficult to accurately determine their value, especially in a timely manner each day. Many of these portfolio investments may have legal or contractual restrictions on their sale, others may be complex instruments, and still others may not trade that often. As portfolio strategies and permissible investments for a fund are being developed, it is essential that the accurate pricing of the portfolio holdings and NAV calculations are carefully considered. It is also important that the services used to assist funds with pricing do so accurately, in the manner disclosed in the fund's prospectus and consistent with the law. This is of high importance to everyone. I, along with your investors, expect that you will get it right."
>
> - **Mary Jo White**
> SEC Chair

Liquidity is clearly of great interest to fund groups who continue to analyze their portfolio positions accordingly. By the same token, business continuity is garnering more industry attention, with fund groups considering how to address any potential disruptions in the availability of a service provider or pricing vendor.

Continuing a theme established in prior years' surveys, this year's findings highlight the continued active role fund boards are playing in addressing these valuation issues and others, and the increased use of dashboards. Active board governance is a key aspect of valuation oversight and suggests that fund groups are not only meeting regulators' expectations, but also continue to add processes to get ahead of the unexpected.

Liquidity

It is no surprise that liquidity is rising in importance on valuation agendas. The most recent credit crisis is not that far behind us, and the SEC's actions over the past year show it is intently focused on keeping liquidity considerations in the foreground.

This year's FV Survey shows more than forty percent of survey participants currently consider liquidity in the determination of some or all of their portfolio positions, and a handful of survey participants indicate they are developing policies in this area. In addition, most fund groups have designated a specific function to be responsible for the initial determination of a security's liquidity, with the front office identified as the most commonly deployed for this purpose. Liquidity is also an important area of interest for many boards, as thirty-five percent of survey participants noted that liquidity is specifically considered as part of the oversight process.

What is the biggest liquidity question relative to valuation? The FV Survey suggests it is the question of how the information is gathered.

How can the information gathered while evaluating a fund's liquidity be used in the valuation of portfolio investments? There is still plenty of uncertainty on this topic, as thirty-five percent of the respondents noted that they needed more guidance on how to better understand the intersection of valuation and liquidity.

Perhaps the most critical area is identifying situations in which decreased liquidity prompts a need to change the most recently quoted price. Some guidance in this area already exists. For example, consider the following instructions from Accounting Standards Codification 820-10-35-54D relative to prices that an entity may have obtained:

"If a reporting entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), further analysis of the transactions or quoted prices is needed."

How to perform this analysis is another question, and one that many fund groups are challenged by since guidance and principles are limited in this area.

Understanding how pricing vendors consider liquidity in determining evaluated prices is one step toward filling in the blanks, as is evaluating how such views line up with the views of a fund group's own traders. That knowledge may bring fund groups closer to resolving whether a pricing vendor's price represents what a likely trading partner would pay the fund group for a position that is less liquid.

A more mature path forward exists for investments in private companies ("private equity" or "private equities") where illiquidity is expected and is considered. The FV Survey suggests this is an area of interest for many mutual funds, as some emerging practices in the valuation of private equities were noted from the prior year. For example, fifteen percent of survey participants indicated that they always use more than one valuation methodology to value private equities, and thirty-three percent indicated that they do so most of the time, compared to zero percent and thirteen percent, respectively, in the prior year. Using multiple methodologies may not yield the perfect answer, but doing so may assist fund groups in drawing a fence around the valuation and provide some comfort on the reasonableness of their key assumptions.

While private equities represent a completely different asset class than traditional stocks and bonds that normally have liquidity, the valuation concepts are likely relevant, especially the idea of having multiple ways to help corroborate a security's value or to identify meaningful data points. To this end, the FV Survey provides a handful of maturing practices that represent opportunities for considering liquidity and valuation, including the following:

Alter internal controls. Twenty-six percent of all survey participants adjust the internal controls that they perform based on the liquidity considerations. This sort of segmentation means adopting a new lens when monitoring these instruments for unchanged prices, day-over-day tolerances, bid-ask spread analysis, and the frequency by which additional sources are obtained or securities are internally modeled. While these are not necessarily novel concepts, this level of focus may help pinpoint situations in which the pricing is becoming less reliable.

Involve risk management personnel. Half of the fund groups that have a risk function indicated that their risk mission or charter includes the assessment of liquidity relative to valuation. Risk-based tools may provide leading indicators of market changes that could help in this respect.

Form a liquidity committee. Twenty-nine percent of fund groups have a specific committee that reviews and considers the liquidity of the fund group's holdings. While by no means required, such a committee may allow for the sharing of data points that may prove more helpful than standard measures, particularly when they consist of a variety of interested parties. Collaboration can be very helpful in addressing developing liquidity concerns.

Fair Valuation Pricing Survey | Fourteenth Edition

Business continuity

The SEC Chair's remarks at the ICI 2016 General Membership Meeting remind us not only of the importance of collaboration, but also of ensuring there are no breaks in the chain. Following her remarks, the SEC released guidance (No. 2016-04) in June 2016 related to business continuity planning—including advisers' oversight of third-party service providers to conduct fund operations. In light of industry events and this SEC guidance, we asked FV Survey participants to indicate what contingency plans existed should the primary fund accountant have delays in striking NAV daily. Respondents were divided on the issue:

- Thirty-nine percent of participants said they would rely on the third-party accountant's contingency plan
- Twenty-seven percent indicated they would calculate NAV based on shadow books or records internally maintained
- Seventeen percent said they would estimate NAV based on index or proxy movement

While they may differ when it comes to such contingency planning, it is clear that all see the importance of ensuring accurate NAV reporting and the ability to deliver this objective in times of need. While it is nearly impossible to develop a list of all scenarios that could compromise fair valuations, fund groups can start by taking real-life scenarios and drawing corollaries to other potential developments. In 2015, for example, many fund groups absorbed the difficulties surrounding the pricing of Greek stocks after the extended halt of Greece's stock market, and many also realized the importance of considering what they would do if the NYSE was closed prior to 4 p.m. EST.

Starting with that premise, fund groups should ask themselves what they would do if an Asian or European stock market closure occurred tomorrow. Have they identified proxies and points of contact for countries in which they hold significant positions?

Going through such a table top exercise may seem tedious or unnecessary, but the reason the industry has demonstrated great ability to persevere in previous times of crisis stems from strong business continuity planning. In a time of relative calmness and with strong momentum at its back, the industry is now presented with a good opportunity to advance contingency planning and prepare for the next unexpected crisis.

The released guidance specifically calls out pricing agents as a critical fund service provider and suggests funds have back-up processes or multiple providers to allow for continued operations in case of disruption by a critical service provider.

Active fund governance

Boards can be supportive in helping fund management navigate through a crisis. Active fund governance and the board's role in the overall valuation process continues to mature into industry practices. The fund board's role to expand its involvement from the approval of policies and procedures to "real-time" involvement on specific valuation matters as price uncertainty enters the market shows that active board governance continues to be a key aspect of valuation oversight. It signals fund boards' willingness to follow regulators' expectations in establishing and monitoring sound valuation policies and procedures.

To provide this heightened degree of oversight, fund boards are being more strategic in working to anticipate risks and potential issues before they arise. The key objective continues to be making sure that the fund board is engaged and at the table during valuation moments that matter. One of the more noticeable trends in the FV Survey is how many fund groups are now using dashboard reporting as a way to highlight key indicators for boards without burying them in excessive amounts of details. More than half of all participants have developed, or are in the process of developing, formal risk dashboards that use key valuation indicators (KVIs) to assist fund boards (or their committees) in the valuation oversight process (fifty-one percent vs. twenty-eight percent last year). Nearly all (ninety-three percent) who use risk dashboards present them at each board/committee meeting to assist in its valuation oversight (up from seventy-six percent in the prior year's survey).

However, just because dashboards are becoming more prevalent doesn't mean they cannot be improved. Dashboard reporting is still relatively new and manual, so some trial-and-error is natural at this stage. When times are relatively calm, it is a good opportunity to take the time to assess how dashboards are being used or could be used, with an eye toward enhancing the effectiveness of the reporting function. Key questions boards may want to ask in this respect include:

- Have the objectives of the dashboard been clearly defined?
- What are the asset classes that are most subject to moments of price uncertainty in volatile markets/environments?
- Do KVIs exist that would help identify when price uncertainty enters the markets?
- Do the KVIs assist in meeting the objectives?
- Is there a mechanism to identify whether the objectives are being met?
- Would a board member be able to identify a developing risk using the dashboard (regardless of whether it was already identified by management)?
- Does an established mechanism exist to monitor warnings identified on the dashboards and, if necessary, to take action?

One area that may be ripe for improvement is how dashboards are currently being created. More than two-thirds (sixty-nine percent) of FV Survey participants who use dashboards are doing so through manual spreadsheets and not automated tools. This suggests the next generation of dashboards may be populated through automated means, allowing for more efficient delivery and perhaps enhanced period-to-period comparisons in the typical green, yellow, and red warning reporting format.

As the valuation process continues to evolve, opportunities to leverage KVIs and risk dashboards should continue to develop to help fund boards and management identify specific valuation matters needing further attention—ultimately helping them make more meaningful and timely decisions relative to the valuation process.

The second maturing fund board trend is the identification of certain circumstances in the valuation policies and procedures whereby non-interested board members "must be involved" or "must be notified." In the FV Survey, forty-eight percent of the participants identified such circumstances compared to forty-seven percent in the prior year.

Situations continue to arise where special valuation attention is necessary, including predetermined events such as market closures, and unforeseen country, industry, or issuer events. Supporting active fund governance has continued to be prevalent. In fact, thirty-nine percent of FV Survey participants indicated their fund groups met to discuss fair valuation issues outside the normal board schedule. Top valuation issues that resulted in such discussions included:

- Thirty-nine percent to discuss trading halts, suspensions, or other market disruptions
- Thirty-six percent to discuss use of a new pricing methodology, pricing vendor, or broker
- Twenty-two percent to discuss market disruption in China

Other valuation issues that prompted a nonscheduled valuation discussion included the Brexit vote, debt payment defaults, odd lot pricing, private placement valuations, and business continuity issues with service providers.

Such active involvement on key emerging matters demonstrates that management and fund boards are monitoring developments closely and that they remain committed to meeting Chair White's expectation that they will "get it right" relative to challenging valuation matters.

Other key findings

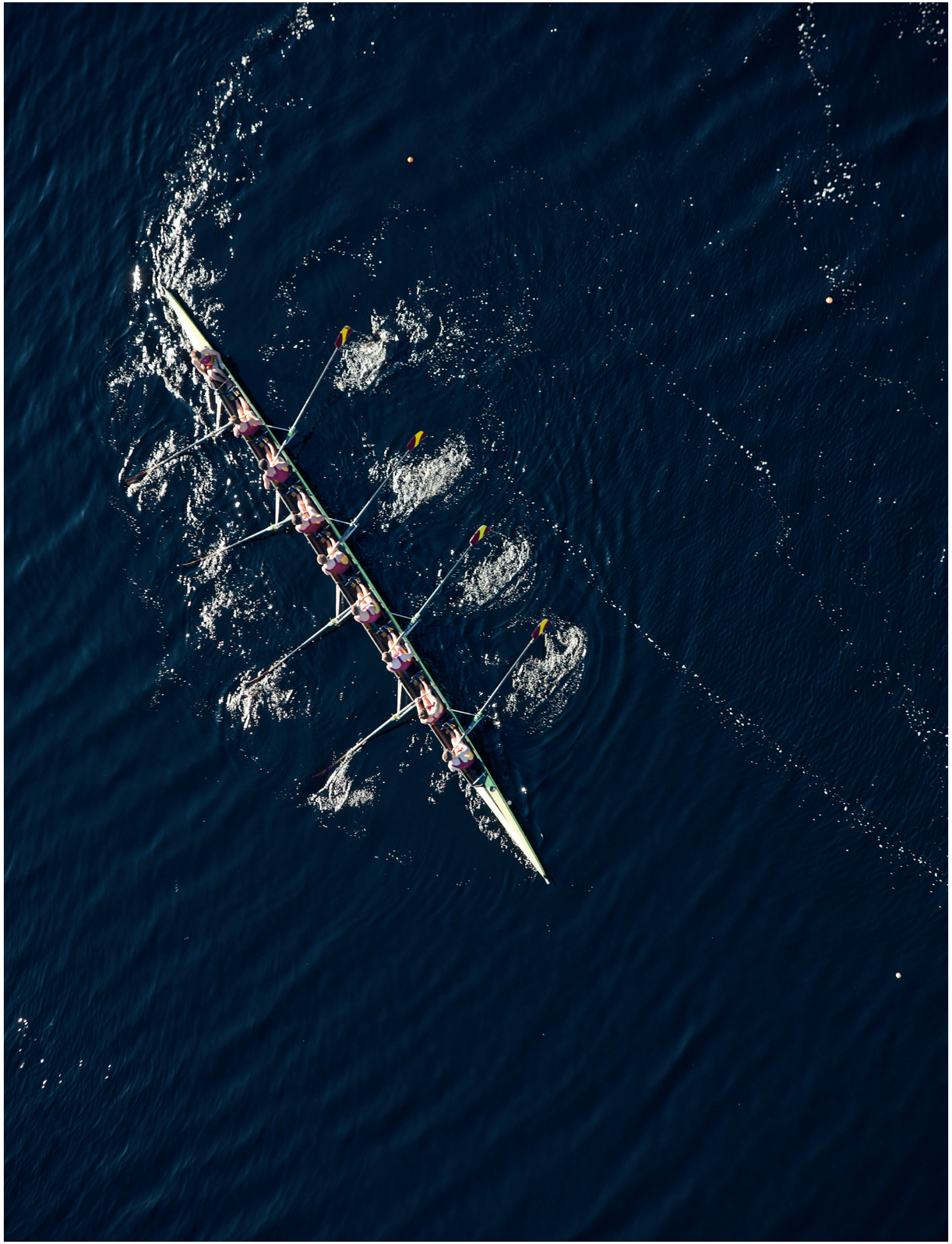
This year's survey brought to light some other notable findings relating to valuation policies and procedures, board governance, and specific investment types, to name a few.

Valuation policies and procedures

- The FV Survey indicates that a majority of participants changed or revised their valuation policies over the past year (sixty-three percent vs. seventy-three percent in the prior year). The most common changes include:
  - Addition of more pricing sources and investment types
  - Pricing committee composition, responsibilities, and/or meeting frequency
- Twenty-five percent and twenty-four percent of survey participants, respectively, reported that they had looked for ways to improve the efficiency of the valuation process and to reduce redundancies and increase the use of automation.
- Seventy-three percent of survey participants use a different pricing source/pricing vendor depending on asset class.
- Fifty-six percent indicated that they would only initiate a price challenge when they have conflicting market data that suggests the price is not accurate. Sixty-nine percent may change a price if they believe it is not accurate even if they have not received a response from the pricing vendor.

Board governance

- Sixty percent of survey participants reported that the full board, a committee of the board, or one or more board members receive information regarding price challenges, compared to fifty-seven percent in the prior year.
- Thirty-six percent reported that the percentage of the overall board agenda dedicated to valuation increased.
- Eleven percent of survey participants reported that the full board or a committee of the board engaged a third-party consultant in the past year to perform an independent valuation of a particular asset class or security.
- Fifteen percent of survey participants reported that at least one non-interested board member attends pricing vendor visits periodically, compared to fourteen percent in the prior year.
- Sixty-one percent of survey participants reported that their boards are receiving information on instances in which the fund groups did not use the primary pricing source, an increase from thirty-two percent in the prior year.



We also noted that some survey participants made changes over the last year in other areas of board governance. Those indicating that they had made a change are shown below, along with the comparative statistics for the prior year:

Aspect of Board Governance Changed	2016	2015
Level of detail provided to the board	30%	45%
Types of material provided to the board changed	15%	38%
Frequency of board discussions on valuation	10%	13%
Delegation of responsibilites by the board	2%	3%

Fair valuation considerations for specific investment types

- Practices across survey participants were divergent relative to what price they would use in the event of an unscheduled NYSE closure, as twenty-six percent reported that they would use a composite price, another twenty-six percent reported that they would use the last NYSE price, and the remainder reported other alternatives.
- Sixteen percent of survey participants reported making process changes relating to the valuation of foreign equities.
- The percentage of survey participants reporting that they use zero triggers was forty-eight percent, up slightly from forty-seven percent reporting such in the prior year.
- For those using triggers, the S&P 500 (most commonly with a fifty basis point trigger) and S&P 500 futures (most commonly with a seventy-five basis point trigger) are the most frequently used proxies.
- Forty-seven percent of survey participants indicated that they receive and apply a standard factor provided by a pricing vendor when adjusting the closing exchange price on foreign equities held in their passively managed exchange-traded funds.
- For fixed-income pricing, twenty-six percent of survey participants have prepared an analysis to determine whether transaction prices for odd-lots are different than round lots, and sixty-seven percent of those survey participants identified either no noticeable difference or mixed or inconclusive results.
- For short-term debt securities with a remaining maturity of sixty days or less, forty-five percent of participants generally attempt to obtain a fair value from a pricing vendor or broker, compared to forty percent reporting such in the prior year.

Other considerations

- Fifty-eight percent of survey participants reported that they have an employee who has specific responsibility to manage and oversee the fund group's valuation process.
- Nine percent of survey participants noted that they had fair-valued cash balances in currency-controlled countries during the last 12 months.
- Seventy-three percent of survey participants noted that the disclosure in the notes to the financial statements regarding how holdings are valued is essentially the same as that shown in the registration statement (as amended).
- Seventy percent of survey participants reported that the SEC proposal on liquidity risk management will have the most impact on the fund industry's valuation process.

Looking Ahead

Valuation continues to be an evergreen process that changes year-over-year. The four main stakeholders (fund sponsors/management, those charged with governance, service providers, and the regulator) will continue to influence what is next for valuation as they collectively work towards the best valuation approaches for investments. In particular, certain matters on the valuation front will bear monitoring in the coming year:

Getting it right

As noted in SEC Chair White's May 2016 remarks, the SEC call to action for management and the fund board is to "get it right." Albeit the objective of management and the fund boards, the regulator's constant eye and high expectations on the mutual fund industry can never be taken lightly.

Use of data for risk sensing

If mutual fund reporting modernization rules are adopted as anticipated, the SEC has indicated that it will use the newly required information to analyze the industry and identify risks. Many believe this may lead to a focus on valuations that are outside the industry mean. This may be especially prevalent with private equity or thinly traded securities that are a challenge to value. The behavioral implications of a fund group not wanting to be an outlier may have an impact on the determination of value.

Intersection of liquidity and valuation

As noted in past and in the current FV Survey, the focus on liquidity and the ability to meet investor redemptions has been intense. However, this discussion continues to evolve into one of the impact of liquidity on the valuation of portfolio holdings. We believe that this is a natural path for the discussion to follow. Service providers will play a role in the outcome as they continue to refine liquidity tools that specify liquidity adjustments, factors, etc. As the FV Survey noted, many are looking to the regulator for further guidance but such a change could add the need for additional resources as well as add more subjectivity and variances to portfolio valuations adjustments, factors, etc.

Staying ahead

As noted in the FV Survey, active fund governance, robust valuation procedures and policies, and risk management programs all facilitate the ability to see the unexpected sooner. KVIs and risk dashboards will continue to evolve with advancements in automation and technology. Management and fund boards have shown the desire to meet to discuss valuation matters that create price uncertainty and have the right team at the table. The ability to do this in a more efficient and measured approach is achievable.

Deloitte's fourteenth annual Fair Valuation Pricing Survey aggregates the views of 96 mutual fund firms, and participants hold more than $5 trillion in assets under management in registered investment companies. 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 2016.

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