



Mutual fund directors and investment advisers digest

Final push — Are you regulatory ready for rule 2a-5 adoption?

It's hard to believe more than a year has passed since the US Securities and Exchange Commission (SEC) adopted Good Faith Determinations of Fair Value rule 2a-5 and rule 31a-4¹ (the "rule" or the "valuation rule") under the Investment Company Act of 1940 ("1940 Act"), and now there is less than seven months until the compliance date of September 8. In reality, for most fund groups and advisers tasked with implementation, there is even less time to make decisions, finalize plans, and propose changes to their valuation operating models as they will want to present these changes to their mutual fund boards starting as early as this upcoming board meeting cycle. Time is ticking and short. With a packed regulatory agenda, talent challenges, and continued disruptions due to the omicron spike and now the Russian invasion of Ukraine, many fund groups may be realizing that there is

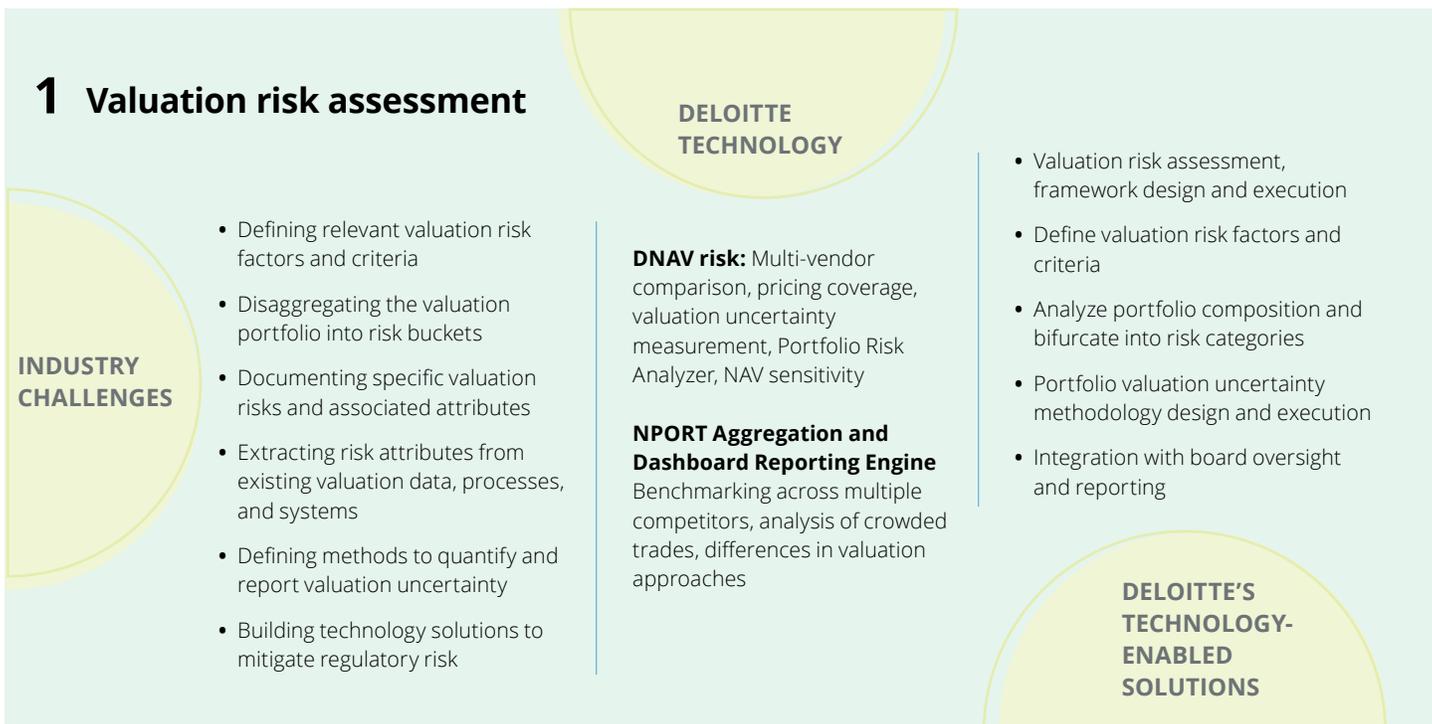
more work to be done to reach compliance. More than a documentation exercise, the rule does have several proscribed activities that require a closer look and expansion of existing industry practices. In this digest we will focus on several industry implementation challenges of rule 2a-5 that fund groups continue to work through to make final valuation operating model decisions.

Industry engagements and surveys, including Deloitte's Fair Valuation Pricing Survey 19th edition,² indicate three main challenges remain. They include the requirement to complete: 1) A valuation risk assessment, 2) Valuation methodology testing and evaluation of pricing services, and 3) The timing and extent of board oversight and reporting. In addition to shedding light on these implementation

challenges, we will offer solutions through Deloitte's industry-leading and technology-enabled tools that can assist fund groups as they implement the rule as well as enhance their valuation operating model and ongoing compliance efforts.

Our broad-based and integrated suite of systems and technology include cloud-based market data solutions powering DNAV (Deloitte's Investment Management auditing platform), analytical engines (such as ValueD), and flexible data aggregation and reporting environment. These tools and solutions maximize the use of technology, industry data and mutualized resources, and through the deployment of centralized and standardized data collection, processing, and assessment help mitigate regulatory risk and achieve desired cost efficiencies and process effectiveness.

Key implementation challenges and industry solutions



Although the investment management industry has been managing certain valuation risks for many years, the SEC rule has introduced several new dimensions to valuation risk requiring additional analysis, such as conflicts of interest, formal valuation risk assessment, and escalation of material risks to enable "active board oversight" and prompt reporting. Furthermore, the SEC did not prescribe an exhaustive list of valuation risks but left room for valuation risks as necessary. As a result, there is an opportunity for fund groups to develop a comprehensive evergreen risk framework

that can be integrated into board reporting. However, the industry appears to be challenged in identifying and consolidating all relevant valuation risks. As of December 2021, approximately 71% of the clients polled during our Deloitte 2a-5 webinar³ have yet to develop a valuation risk assessment framework. Deloitte will leverage its industry-leading technology and capabilities to help clients develop a multidimensional and comprehensive valuation risk assessment framework, which includes conflicts of interest, and integrate it with board reporting.

2 Valuation methodology testing and evaluation of pricing services

INDUSTRY CHALLENGES

- Insufficient transactional information to run back-testing analysis and model testing
- Lack of trade calibration methodology to align with end-of-day vendor prices
- Insufficient pricing vendor support/relevant product and consistent cross-vendor back-testing methodology complicating comparative vendor-to-vendor analysis of testing outcomes
- Significant investments in technology and technical resources to run computational analysis, model testing, and data visualization to mitigate regulatory risk
- Insufficient level of details in legacy valuation methodology documentation
- Model development documentation and testing are lacking.

DELOITTE TECHNOLOGY

DNAV valuation testing:

Combines digital technologies, automation, data science, and artificial intelligence

- Manage vendor exceptions and back-testing
- Automated derivatives modeling and pricing
- Advanced data visualization

Valued: Calculation engine reporting and project management

- Test accepted fair value methodologies
- Automated pricing of fixed-income instruments
- Highly automated private debt valuation

Market data sets, data hosting, and "repository"

- Multi-vendor price back-testing
 - Deploys private and public transactional data
 - Standardized vendor price testing approach
- Price exception management process enhancement
 - Risk-based attribution of pricing movements
 - Stale price management
- NAV testing
 - Apply alternative market data, perform shadow pricing, and derive independent NAV
- Integration with board oversight and reporting dashboard
- Hard-to-value asset price testing
 - Develop independent price estimates using Deloitte's valuation approach, models, and a set of independent inputs
- Valuation methodology documentation enhancement

DELOITTE'S TECHNOLOGY-ENABLED SOLUTIONS

The SEC noted that while "calibration and back-testing are methods that should be used for testing the appropriateness and accuracy of funds fair value methodologies in many circumstances, the rule does not require calibration and back-testing, nor does it preclude boards or valuation designees, where applicable, from using other appropriate testing methods." ⁴ We note that the industry continues experiencing challenges in both satisfying this rule and designing

appropriate testing methods and programs for both vendor priced investments and hard-to-value assets. Through the deployment of tools, accelerators and technology, Deloitte developed a suite of solutions, including multi-vendor back-testing and price exception management among others, to help clients accelerate their compliance programs.

3 Timing and extent of board oversight and reporting

INDUSTRY CHALLENGES

- Identification and reporting material changes in valuation risk and process
- Integration of results derived from valuation control processes such as valuation methodology testing, price exception management, assessment of conflicts, etc.

DELOITTE TECHNOLOGY

Customized client solutions

NPORT Aggregation and Dashboard Reporting Engine

Benchmarking across multiple competitors, analysis of crowded trades, differences in valuation approaches

- Assess board reporting against rule requirements and industry-leading practices
- Implement required board reporting enhancements including dashboards, Key Valuation Indicators ("KVIs"), and other tailored solutions
- Integrate valuation process and control outcomes into board reporting

DELOITTE'S TECHNOLOGY-ENABLED SOLUTIONS

Although the board reporting process has evolved over the years, the industry continues to rationalize its board oversight and reporting framework to incorporate additional requirements of the rule, such as valuation risk assessment outcomes, while

seeking ways to maintain an efficient and effective process. Post rule 2a-5 implementation, board reporting will be critical to allow boards to support their "active board oversight" mandate and manage regulatory risk.

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Endnotes

1. US Securities and Exchange Commission "[Rule 2a-5: Good Faith Determinations of Fair Value](#)," released December 3, 2020.
2. [Deloitte's 2021 Fair Valuation Pricing Survey, 19th edition](#), September 29, 2021.
3. Webinar: Deloitte 2a-5 Valuation Accelerators & Solutions: Are you ready?, December 6, 2021.
4. US Securities and Exchange Commission "[Rule 2a-5: Good Faith Determinations of Fair Value](#)," released December 3, 2020.
5. Ibid.

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