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Now that the dust has settled

Revisiting the oversight process of alternative investments

As the investment industry concludes one of the more volatile and challenging periods, it is becoming increasingly fashionable and an industry trend to accelerate and expand the manufacturing of alternative products. In fact, over the past 30 years, alternatives have evolved from a cottage industry to a cornerstone of asset management. Traditional mutual fund shops have continued to expand their product lineups to include alternative products in the form of interval funds, private equity, private debt, infrastructure, natural resources, and real estate funds, as well as business development companies (BDCs). While the appeal to launch alternative products and seek to generate higher alpha and grow assets under management (AUM) is alluring, such products come with portfolio holdings that increase complexity and create challenges to the fund groups' valuation operating model and the board valuation oversight process. "Alternative investments" is a generic term that may not be perfectly defined, but it generally refers to investments in equity interests and fixed-income instruments that do not trade on the public markets, are not backed by a financial institution, and are often less liquid.

Further, some mutual funds registered under the Investment Company Act of 1940 (the"Act") have expanded their investment strategies to invest a portion of their capital in alternative investments with the goal to add alpha.

Mutual funds are limited to holding up to 15% of their portfolio in illiquid assets such as alternative investments. Beyond having a strategy to invest in private equities or private credit instruments. It should be noted that mutual funds sometimes receive these types of investments in circumstances outside of their control. For example, certain corporate actions may result in spun-off private companies or restructured debt or equity investments, or more liquid investments may become less liquid or truly private through de-listings or mergers and acquisitions.

In the 20th edition of the Deloitte Fair Valuation Pricing Survey (the "FV Survey"), published in September 2022, more than 50% of the 90 survey participants noted that they hold private equities. In the 19th edition of the survey, released in September 2021, 50% of survey participant fund groups investing in private equities noted that their investments in such holdings had increased as a result of new market acquisitions or through restructurings.

In summary, even funds without a focused strategy to invest in alternative investments may end up holding one or more of these instruments. Thus, it can become a point of interest for a majority of funds and their boards and a good practice to establish valuation governance protocols and enhancements to the valuation operating model.

Valuing private equities and private credit investments

Valuation of such instruments is, of course, not simple, often because data and information necessary to value such investments may be less available or not current and/or because certain inputs and assumptions needed for their valuation are, by nature, very subjective. This can make valuations extremely difficult for 1940 Act mutual funds, especially those that execute shareholder transactions daily based on the net asset value (NAV) per share of the fund.

Determining the fair valuation of such investments is naturally important. Even small investments can affect the NAV of management fees and any other asset-based fees that the fund incurs. Valuations that are "conservative" may reduce the risk that a fund incurs excessive fees. However, for open-end funds, it can still lead to an incorrect NAV on *each and every* day that the NAV is calculated, disadvantaging certain fund investors.

As a result, determining an accurate fair value, as defined under US generally accepted accounting principles (US GAAP), is essential every day that a fund determines a NAV. The US GAAP requirements, detailed in the FASB's Accounting Standards Codification (ASC) 820, provide principles that a preparer must apply in determining fair value, but such are not necessarily prescriptive. They do, however, place a premium on the use of any observable inputs to value investments that do not have readily determinable fair values. They also require that the mutual fund put itself in the shoes of a hypothetical buyer and/or seller, known as market participants. Shown below is a passage of a market participant within ASC 820.

A reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest. In developing those assumptions, a reporting entity need not identify specific market participants.

While a mutual fund does not have to identify the exact market participant, US GAAP does provide a general definition of such:

Market participants
Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

- They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
- They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
- They are able to enter into a transaction for the asset or liability
- They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so

A key point in the text is that the mutual fund cannot solely price an investment based on what the adviser or portfolio manager thinks the investment is worth but rather must value from the lens of a market participant, even if that participant may be hypothetical. The mutual fund also must value an investment using information that a market participant could obtain through normal due diligence. Thus, it's imperative to consider what information a market participant would receive or be able to obtain if interested in purchasing the investment. It's also important that the most current information is used or considered each day to determine the fair value.

What the adopting release of rule 2a-5 may tell us about the SEC's expectations

Fund groups spent considerable time refining their respective approaches to their valuation operating model when implementing US Securities and Exchange Commission's (SEC) rule 2a-5 under the 1940 Act (the "Rule"), which funds were required to implement by September 8, 2022. More than 90% of FV Survey participants indicated that they spent a moderate or significant amount of time, effort, and expense on implementing the Rule. Fair valuation has never been a static process for fund groups. The Rule certainly provided a catalyst for change.

The Rule itself does not require that fund groups make changes to how they value private equities and private credit products. However, the "adopting release" of the Rule sheds light on the SEC's expectation on how mutual funds and their boards should consider this asset class relative to valuation. The adopting release is clear in stating that "the Rule sets forth certain required functions that must be performed to determine the fair value of the fund's investments in good faith." Thus, the Rule reflects what a mutual fund needs to perform when valuing an investment without a readily determinable fair value.

What follows are some key points relating to certain aspects of the Rule.

Periodically assess and manage valuation risks

The adopting release highlights that the SEC expects that mutual funds will identify the key inputs and assumptions necessary to value alternative investments and that such is critical to meeting the requirements of the Rule.

The final rule requires the board or valuation designee, as applicable, to select and apply in a consistent manner an appropriate methodology or methodologies for determining (which includes calculating) the fair value of fund investments. As proposed, to satisfy this requirement, the board or valuation designee, as applicable, will have to specify the key inputs and assumptions specific to each asset class or portfolio holding.

As stated in the adopting release, regarding the key inputs and assumptions specific to each asset class or portfolio holding, it would not be sufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing:

- Any additional detail on the specific qualitative and quantitative factors to be considered
- The sources of the methodology's inputs and assumptions
- And a description of how the calculation is to be performed.

This suggests that the risks related to valuing alternative investments should be specific, identifying the inputs that go into the calculation and where they come from, understanding the assumptions and the model used to calculate the value, and what may drive the decision that they are appropriate. Because this is part of the "periodically assess and manage valuation risks" section, it is assumed that there would be a mechanism in place to periodically monitor the appropriateness of what is being used. That's especially important for an open-end fund that depends on appropriate valuations of all investments each day in order to calculate an accurate NAV.

Test fair value methodologies for appropriateness and accuracy

There are different methodologies that fund groups use to value their investments. A recent survey released by Deloitte that targeted funds that hold private equities, private credit instruments, and venture capital (the "Deloitte PE Survey") found that 40% of participants indicated that their policy is to use more than one methodology when valuating an investment, 13% indicated that their policy is to use a single methodology, while another 40% indicated that their policy only requires the use of one methodology, although they may occasionally use more than one methodology.[1]

Given the potential for different viewpoints, testing the methodologies can be very important. The adopting release focuses on the potential for using calibration and back-testing to assist in testing fair value methodologies. Calibration is especially pertinent to private investments because it helps align the output from a model to a transaction price.

In the 2022 FV Survey, 50% of survey participants with investments in private equities indicated that they are maintaining internal documentation of their consideration of calibration for their private equity investments, up from 34% reporting this in the previous survey.

Pricing services

In the 2022 FV Survey, 31% noted that they employ a third-party valuation specialist to assist with valuing private equities. Additionally, the Deloitte PE Survey found that 90% of participants that manage a business development company indicated that they use a valuation specialist.[2]

Of the items mentioned in the sidebar, (i), (ii), and (v) are especially relevant to private equities and private credit instruments. For example, it's possible that a third-party

Calibration can assist in assessing whether the fund's valuation technique reflects current market conditions, and whether any adjustments to the valuation technique are appropriate. "Calibration" for these purposes is the process of monitoring and evaluating whether there are material differences between the actual price the fund paid to acquire portfolio holdings that received a fair value under the 1940 Act and the prices calculated for those holdings by the fund's fair value methodology at the time of acquisition.

Using a Pricing Service/Valuation Specialist: The adopting release highlights the following requirements when a fund uses a pricing service/ valuation specialist.

We believe that under the Rule, before deciding to use a pricing service, the fund's board or valuation designee, as applicable, generally should take into consideration factors such as:

(i) the qualifications, experience, and history of the pricing service
(ii) the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected (if at all) as market conditions change
(iii) the quality of the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates its net asset value
(iv) the pricing service's process for considering price challenges, including how the pricing service incorporates information received from price challenges into its pricing information;
(v) the pricing service's actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and
(vi) the testing processes used by the pricing service.

specialist may have less experience with certain types of investments. Additionally, they may take certain direction from those employing them—such as members of the investment adviser—on the inputs, assumptions, and methodologies to use, and boards may want to understand that. Third-party specialists may also be employed to provide other services to the investment adviser, creating a potential conflict of interest.

Board valuation "active" oversight

The SEC has clear expectations that boards will more carefully consider investment risk in determining the level of oversight they provide.

We expect that boards engaged in this process would use the appropriate level of scrutiny based on the fund's valuation risk, including the extent to which the fair value of the fund's investments depends on subjective inputs. For example, a board's scrutiny would likely be different if a fund invests in publicly traded foreign companies than if the fund invests in private early stage companies. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, we expect that the board's level of scrutiny would increase correspondingly.

Considerations for board members

Implementation of the Rule has occurred, but that does not mean that the valuation operating model will now continue to be evergreen, nor does it mean that board valuation oversight should be any less active. One area in which the board may want to focus more time and effort is the valuation of private equities and private credit investments. This is not to say that boards have not spent time in this area. Many have spent considerable amounts of time. The Rule provides a path for boards and their desigees to develop valuation proceduresfor these investments through the risk assessment process. In our Deloitte PE Survey, 85% of the participants have a formal valuation committee to oversee their valuations. Also, the use of a valuation specialist has skyrocketed from only 30% in our first PE Survey edition to 70% in the (latest) sixth edition, with 41% noting that they use an external fair valuation specialist as their primary source for their valuations. Aligned with these thoughts, what follows are some key points that boards and their designees may want to consider relative to private equities and private credit instruments.

- ***Population of investments*** – Understanding the full population of investments for which traditional valuation sources, such as third-party pricing vendors or broker-dealers who truly might be market makers for a particular investment, do not exist might be a good first step. Also, for example, scrutinizing those investments that are marked at a zero value to assess why their fair value is zero and whether it should or could be higher might also help in evaluating the extent of the population.
- ***Appropriateness of model used*** – Understanding the process the valuation preparer goes through to calibrate the model to a recent transaction price as it relates to matters such as the discount rate used in a discounted cash flow analysis or a selected multiple used in a market multiple-based technique. Transaction prices are great sources of information, but it's always important to understand if a transaction relates to the exact investments, including various tranches or classes that might be held, and if they are truly representative of what a market participant might pay (i.e., not a forced or bankruptcy transaction).
- ***Impact of inputs and assumptions used to determine valuation*** – When there is subjectivity in the inputs and assumptions used, additional scrutiny may be required to be consistent with the SEC's expectations. This may involve understanding how the preparer assesses each input and assumption and why preparer concludes that the ones used are most appropriate. Additionally, it may be prudent to understand how the preparer monitors for changes. For a mutual fund, it is likely important to understand how the mutual fund monitors each day for changes that might affect the valuation of the investment.

  Understanding the sensitivity of certain inputs and assumptions to the calculated valuation may also help a board determine where to focus its attention.
- ***Adequacy of valuation resources*** – Under the Rule, the valuation designee must provide boards with an annual report that assesses the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value. To the extent the nature of investments changes, boards may want to understand the expertise of the people involved in preparing and overseeing valuation, their capacity to provide sufficient time in determining valuations, and their ability to access information that is critical to the valuation. For example, if certain pertinent matters about an investee's performance or events affecting an investment are only known by investment professionals, does the valuation preparer have ready access to such professionals, and is there a communication line to allow for real-time information sharing that relates to matters to which a market participant, performing customary due diligence, would have access? In the recent Deloitte PE Survey, 60% of industry participants have adopted file-sharing platforms or cloud-based software for aggregating portfolio company information, which may potentially provide better access to relevant information.[3]
- ***Potential conflicts relating to members of the valuation team*** – The Rule certainly addresses the potential for conflicts of interest with those involved in the valuation process. Understanding the information and data provided by investment professionals to assist in determining fair value and what controls are in place to facilitate the accuracy and appropriateness of such may be necessary.

It's also essential to understand the potential bias in the valuation determination, even if an external party is involved to assist in the process.

What's next

As the search for alpha continues to consume active managers, we believe that investments in alternative investments will continue to grow as part of the mutual fund's portfolio holding as well as the continued launch of alternative products. This will continue to present a challenge to the valuation operating model and the board oversight model.

For many of the private equity success stories there are often other private equity investments that come with a cautionary tale. The Rule provides fund groups with another opportunity to revisit and refine their current practices. Keeping the communication lines between fund management and the board open with regards to alternative investments will go a long way to facilitating accurate and timely valuations.

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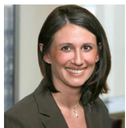

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Endnotes

1. *Deloitte's 2022 Fair Valuation Pricing Survey, 20th edition*, October, 2022.
2. Ibid.
3. Ibid.

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