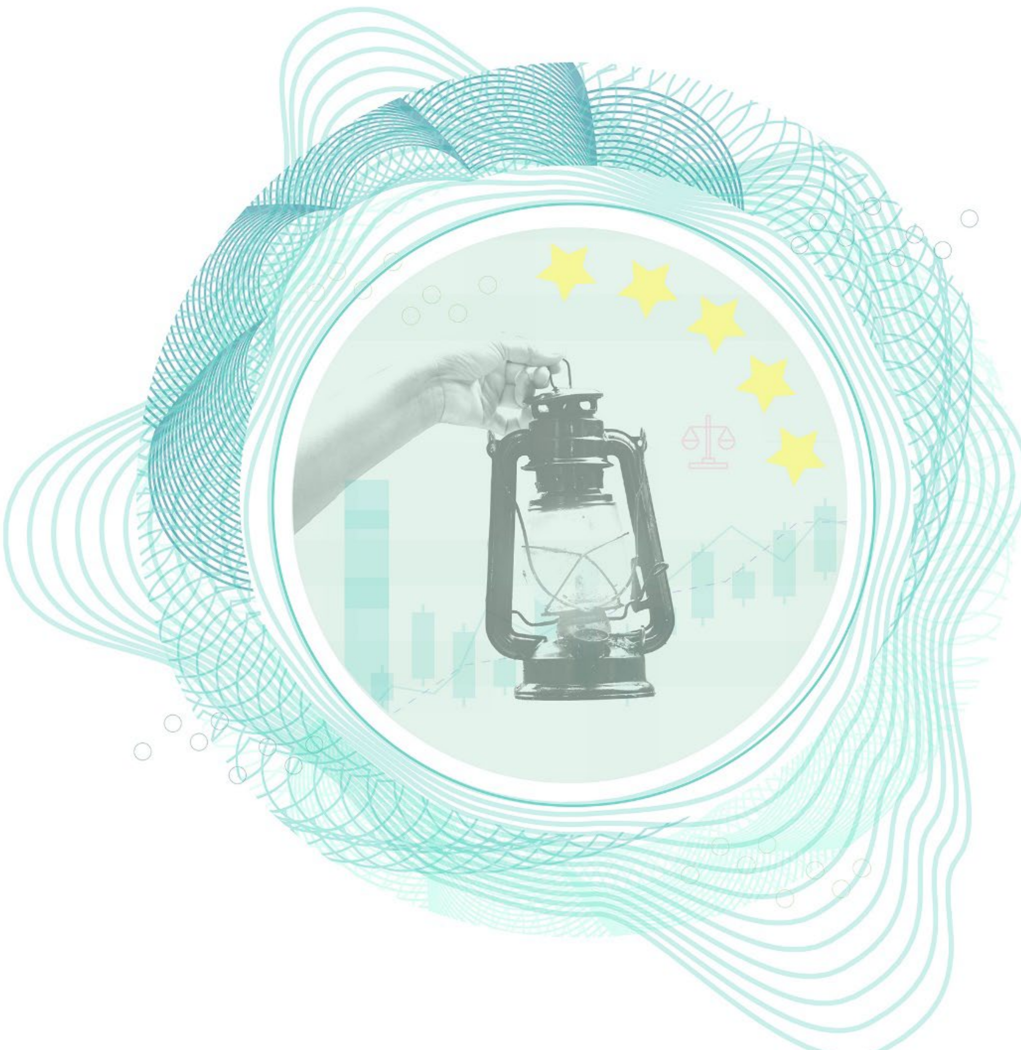


Fair valuation pricing survey, 20th edition, executive summary

Finding new paths forward

Contents

Finding new paths forward

Welcome to our 20th edition of the Deloitte Fair Valuation Pricing Survey (the "FV survey"). What started out as a vision to help our clients understand how evolutions in the capital markets, in governance, and in the regulators' activities and expectations were affecting fund groups' valuation operating models has now developed into a rich source of information highlighting emerging, maturing, and stabilized industry valuation trends and practices. Many of the original 47 participants in that first survey are still with us today. We thank them and all the fund groups who have participated over the years. Your commitment to enhancing fair valuation practices, policies, and procedures as well as the valuation operating model have benefited mutual fund stakeholders immensely. The commitment in time, resources, and investment by the fund industry has been impressive. Together, we're anticipating challenges and finding and sharing new ways to overcome them. As with the 1st edition of the Deloitte Fair Valuation Pricing Survey, the 20th edition of the Deloitte Fair Valuation Pricing Survey provides general benchmarking for fund groups as they move forward and enhance their valuation operating model.

Over our 20-plus years together, there have been unprecedented global events that have included wars, market crashes, credit crises, pandemics, and scandals. Sometimes these events have an effect on our personal lives, our industry, and jobs, and/or the people with whom we live and work with. Even if they do not, they can infiltrate our well-being, deflating our hearts and spirits. Yet, somehow, we find a new path forward and persevere.

The last year has been no different and was not immune to these events and struggles. There were several events that impacted those responsible for valuing the investments of investment companies every day and/or for overseeing the valuation process. These events included both the continued emergence of COVID-19 variants that influenced decision-making around the future of work and Russia's invasion of Ukraine that upset market prices for certain investments in the region. Additionally, fund groups had to contend with the adoption of the Securities and Exchange Commission's (SEC) rule 2a-5 ("Rule 2a-5" or the "Rule") of the Investment Company Act of 1940 (the "Act") by the required implementation date of September 8, 2022. As each of these and other events emerged, the need for clear and concise communication between the fund directors

and management was critical. These key valuation stakeholders are forever locked together in the valuation process.

Together, these parties have captured the lessons learned from many of the events over the past 20 years and incorporated them into both their fair valuation policies and procedures and their valuation operating models to come out the other side more resilient and prepared for the next challenge.

Compliance with Rule 2a-5: Dominating the agenda
If there were just one overall headline for the 20th edition of the Deloitte Fair Valuation Pricing Survey, it was that Rule 2a-5 left a mark and dominated the past year agenda.

Although the SEC's adopting release of Rule 2a-5[1] noted the SEC's expectation "that the requirements of the final rule align with current practice of fair value determinations of investments without readily available market quotations," the SEC's own estimates that the cost of implementing Rule 2a-5 and its companion rule, rule 31a-4, might be $100,000 or more per fund clearly foreshadowed that the Rule would take effort.

In the 19th edition of the Deloitte Fair Valuation Pricing Survey, participants also predicted that there was work to be done, as depicted in Figure 1.

Figure 1. Areas where current practice was expected to differ from requirements of the FV Rule *(Source: 19th edition of the FV survey)*

Aspect addressed in FV Rule	Percentage identifying gap
Board reporting	69%
Risk assessment procedures	67%
Periodic testing procedures	45%
Evaluation of fair value methodologies	40%
Assessment of third-party pricing providers	33%
Recordkeeping	33%

The 20th edition of the FV survey results affirmed that hypothesis, as more than 90% of those completing the FV survey indicated that the adoption of the Rule resulted in their fund group allocating a moderate or significant amount of time, effort, and/or expense on implementation in the backdrop of severe market volatility, uncertain work requirements, and geopolitical events and conflicts. Specifically, 38% of FV survey participants described the efforts they spent on implementing the Rule as "significant" while another 55% described the efforts as "moderate."

One may think that a valuation rule itself might actually change how fund groups *value* their investments, but that is not necessarily true with Rule 2a-5. Although the FV survey showed that some fund groups made changes in how they value subsets of their holdings, as highlighted in the "Other key survey findings" section, there is no clear evidence in the FV survey that such changes were the result of the adoption of the Rule. Instead, those changes were more likely just a result of the continuous cycle of study and evaluation of practices that fund groups have been performing for years.

The Rule itself was not really designed to have an immediate effect on the net asset values calculated by fund groups. It was, however, designed to affect elements of the valuation operating model and to provide clarification on the roles and responsibilities of mutual fund directors and the oversight that goes with it, always with the end objective of promoting more reliable valuations.

To this end, the Rule specifically required changes in reporting to boards of directors/trustees (the "board" or "boards"), and the FV survey results highlight the impact on board reporting as well as their responsibilities and interactions with management. The FV survey also highlights new requirements regarding how fund groups assess valuation risks and how they oversee pricing services. Somewhat surprisingly, the Rule seemed also to be a catalyst for the adoption of technology, as fund groups implemented or are working on technological solutions to their valuation operating model for a variety of reasons, including, but not limited to, board reporting. Each of these topics are explored in greater detail on the following pages.

Overall, the FV survey results show that fund groups took several steps to align current practices with the very specific requirements of the Rule. The results also illustrate diversity in the interpretation of the nature and extent of changes required. The result is that the divergence in practice that existed prior to implementation is still very much present. Additionally, the jury is still out as to whether the potential benefits of the Rule outlined by the SEC will come to fruition.

What did the SEC outline in the adopting release as benefits of Rule 2a-5?

"The final rule helps the board oversee the fund and helps to promote, for example, the mitigation of conflicts of interest of those involved in the fair value process and in the management of investments and the management of the fund for the benefit of the fund's shareholders.

Another benefit arising from appropriate oversight of the fair value process is that fair value determinations will be more likely to reflect a price that could be obtained in arm's-length transactions with less bias. This will contribute to better measurement of the risk and return profile of individual investments and their contribution to the risk and return profile of the fund, which will help promote the management of the fund in accordance with its investment objectives; ensure the accuracy of asset-based and performance-based fee calculations; and affect the accuracy of disclosures of fund fees, performance, NAV, and portfolio holdings."

Board oversight evolves under Rule 2a-5

Perhaps the founding tenet of the Rule was to explicitly permit boards to appoint the investment adviser as its valuation designee in carrying out responsibilities under the Act, and 92% indeed said that they will do that. This allowed the industry to solidify the delegation model that existed in practice, as nearly all FV survey participants indicated that the responsibilities of the boards or one of its committees has essentially remained the same. This suggests that the board oversight model, as it existed before Rule 2a-5, has largely been affirmed. However, the Rule is clear that boards, under the valuation designee model, must practice active oversight that is based on risk, as outlined in the passage below from the adopting release of the Rule:

"Boards should approach their oversight of the performance of fair value determinations by the valuation designee of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it."

The Rule requires that valuation designees report certain matters to the board and the cadence of when they must be communicated. However, designees may provide more information to boards and provide reporting more frequently, if a board would find it beneficial, as shown below:

"These are minimum requirements and boards may find, depending on the facts and circumstances, that additional information is necessary or appropriate in order to discharge their oversight responsibilities appropriately."

The FV survey results found that although fund groups mainly focused on meeting the compliance requirements, some also made decisions relating to interpreting the board's ongoing responsibilities as well as reassessing board reporting beyond what was specifically required by Rule 2a-5.

Ratification revisited

One matter that seemed front and center on the docket for many fund groups was whether the board needed to ratify valuation-related evaluations and determinations made by investment adviser personnel in order to fulfill its duties under the Act. For example, does the board need to ratify management's evaluation of pricing sources? In practice and in previous editions of the FV survey, the answer was most commonly "yes," but that seems to be changing as a result of Rule 2a-5. Relative to the participation and/or ratification of the reevaluation of pricing sources performed by management, 55% of FV survey participants indicated that boards will continue to do this, down from 79% last year.

The decline is steeper for the ratification of the determination of prices. When we first asked about the ratification of pricing determinations back in 2004, approximately 75% indicated that boards ratified prices. That has changed little over the years, as 66% of current FV survey participants had previously concluded that boards needed to formally ratify management's valuation determinations for investments not priced by either a vendor or a broker ("Level 3 investments"). However, only 27% of those FV survey participants are continuing the practice. This shows a clear change in mindset in what boards are required to do under Rule 2a-5.

A few FV survey participants indicated that this movement away from ratification may result in their boards no longer receiving detailed memos to support fair value decisions, although such change does not appear to be widespread. Thus, the removal of a formal ratification process itself may be a change more in form than in substance.

Board reporting: Front and center

While many boards will no longer formally go through a ratification process, thus far only a few fund groups in the FV survey reported true changes in what the board is expected to review relative to Level 3 investments. However, FV survey participants did identify changes in board reporting for several other valuation-related areas. FV survey participants indicated that board reporting will increase in the areas shown in figure 2.

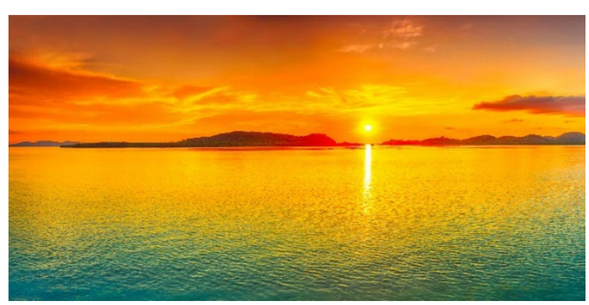


Figure 2. Areas in which board reporting will increase as a result of Rule 2a-5 adoption

Areas in which the board will receive more information	Percentage reporting increase
Back-testing results	57%
Price challenge results	35%
Calibration results	14%
Use of secondary price sources instead of primary sources	14%
Internally fair-valued securities	11%
Use of internal modeling as opposed to primary source	8%

Back-testing, the comparison of recent valuations against actual transaction prices, was one area specifically mentioned in the adopting release of the Rule, and 51% of FV survey participants indicated that their boards will receive back-testing related to valuations that require more subjective judgments, commonly referred to as Level 3 investments, compared to just 36% last year and 29% reporting such in the FV survey two years ago.

The FV survey results also show that some fund groups used Rule 2a-5 as an opportunity to reassess board reporting, perhaps to make reporting more streamlined, risk-based allowing for easier absorption and the ability to highlight key valuation indicators (KVIs). Twenty-five percent of FV survey participants reported that, in the past 12 months, there had been a review of the valuation board reports in order to optimize them. For example, 47% indicated that the Rule is impacting their approach to dashboard reporting. Three fund groups indicated that they will provide valuation dashboards never previously provided to the board. Others indicated the addition of various KVIs, such as back-testing results, as well as the inclusion of risk factors.

Dashboards are designed to be helpful for their specific users, and so they naturally vary in shape and form based on preference, as illustrated in figure 3, and they also vary as it relates to what is included within them, as shown in figure 4.

As noted, the Rule is fairly prescriptive and provides certain matters on which the valuation designee must report to the board, but the Rule does not indicate the format of board reporting and the exact information it should contain. For this reason, disparity exists at the onset of the Rule. Based on the FV survey results, while more boards might receive back-testing information for fair-valued investments, a very meaningful minority still will not. Sixty-seven percent will receive information on price challenges (either in a dashboard format or in some other format), another area specifically addressed in the adopting release of the Rule, but 33% will not, virtually unchanged from the prior year.

Figure 3. Size and format of existing dashboards

Contents	Percentage of those who generate dashboards for boards
1-2 pages containing just KVIs	24%
1-2 pages containing KVIs and analysis	13%
More than 2 pages containing just KVIs	13%
More than 2 pages containing KVIs and analysis	50%

Figure 4. Select KVIs appearing on dashboards

KVIs	Percentage of those who generate dashboards for boards
Back-testing results (trades) – Number and/or percentage of portfolio value	86%
Number of price challenges	74%
Back-testing results (foreign fair value factors) – Number and/or percentage of portfolio value	71%
Price challenges up in price vs. down in price	45%
Valuation source change	24%

Determining when to report is judgmental

Ultimately, the initial changes associated with Rule 2a-5 might be much more about the timing of when boards receive information than the specific information they receive. Similar to the past, 39% of FV survey participants indicated that they held ad hoc meetings to discuss a valuation matter outside the scheduled meeting cadence. This is up from 30% in the prior year.

Rule 2a-5 may replace such ad hoc meetings with more prescriptive reporting, However, some of those requirements are driven by the concept of materiality. The valuation designee is required to report certain matters to the board that are “material.” However, the Rule does not define what is material, providing latitude to each fund group and board to reach their own conclusions. The FV survey results suggest that if the matter relates to something that has a quantitative aspect to it, most use a quantitative measure, although there are two distinct camps on the measurement of materiality to use, as illustrated in figure 5.

Figure 5. How materiality is defined for reporting to the board

	Penny per share	Reprocessing threshold	Reasonable person standard	Other
Matters materially affecting the valuation of an investment (Prompt notification requirement)	55%	24%	7%	14%
Material changes to, or material deviations from, the fair value methodologies (Quarterly reporting requirement)	55%	16%	11%	18%

Where it is not quantitative—such as material changes in the valuation designee's process for selecting and overseeing pricing services and conflicts of interest, less than a third of FV survey participants have developed or are developing general decision criteria. Most will, instead, opt for judgment based on the facts and circumstances.

Likewise, while the board will be responsible for evaluating the adequacy of valuation resources, just 16% have established or are establishing metrics to do so, with most still considering how to do this. This is a tough area, since there are not any published guardrails to help boards assess the number and qualifications of valuation resources.

Lastly, the valuation designee has a responsibility to assess annually the accuracy of valuation methodologies and to present that assessment to the board. The "annual" part of this is really a reporting concept, since most fund groups, to some extent, are doing this daily. Eighty-nine percent of FV survey participants indicated that they will perform testing throughout the year, but there is divergence as to when that should be reported, with 38% indicating that they will still report results throughout the year and 51% indicating that they will just do so annually.

Rule 2a-5 has impacted what must be reported to boards by creating categories of information so that boards have information that the SEC believes is important for active oversight and better investment valuations. This level of structure creates a perceived sense of order that suggests consistency in practice across the fund industry. However, the reality may be less congruent than expected. Fund groups will still make judgments as to the board's responsibilities and how to carry them out, as well as make differing judgments on risk. While many may be more comfortable with this latitude, the variability it creates may make some of the Rule's objectives more difficult to achieve.

Rule 2a-5 brings about a new approach to valuation risk assessments

The Rule requirement to assess and manage material valuation risk, including conflicts of interest, was an item that many participants in the 19th edition of the fair value survey felt might involve the largest lift. The 20th edition found that a year later, the sentiment remained, as 65% of FV survey participants considered it to be the largest challenge of implementing the Rule. Most had indicated that they had historically only identified a few high-level risks for valuation, and that such might not have been formally documented in writing. Perhaps even more fundamental is that only 13% had previously concluded how to define what a "material" valuation risk even means.

While most (74%) FV survey participants have now defined what "material" means in the context of risk assessment, the decision is not uniform. Similar to what appeared in the previous section, 43% of all FV survey participants have tied the concept to a NAV error, meaning that a risk is material if, not mitigated successfully, it would result in a NAV error, as defined within the fund group's policies and procedures (commonly viewed as an error in excess of a penny per share). Still 14% have set the mark higher, using a similar concept but only defining it as to what would require the reprocessing of shareholder trading (often set at 0.5% of NAV) if incorrect. Just 7% look to what a reasonable person might believe is material, relying more on a subjective approach than on a quantitative measure. Determining what might be a material risk was only part of the story. The next question was how granular fund groups would get in risk assessment. Would they become extremely detailed, and would they identify risks in excess of the handful identified by the SEC in its adopting release of the Rule? The FV survey results on this topic are as follows:

- As seen in the FV survey, two viewpoints have emerged in regard to how many valuation risks are identified and how those risks are documented: 52% of FV survey participants have identified five or fewer high-level/general risks while the remainder of participants have specified risks in greater detail.
- Most FV survey participants focused only on the risks identified by the SEC in its adopting release of the Rule. Only 15% indicated that they identified risks in addition to the examples provided by the SEC.
- As for where those risks are documented, 46% of FV survey participants have included the identified risks within the valuation policies and procedures, while others have housed risk documentation elsewhere.

It remains to be seen if consensus will emerge in these areas as fund groups continue to fine-tune their valuation operating models to the risk assessment component of the Rule.

However, one thing that has emerged is something that the Rule really did not formally require. It's how risks specifically get monitored and tracked. What was once more informal, with perhaps very few risks identified and often done as part of a chief compliance officer's assessment, has now become something more sophisticated. More than 75% of FV survey participants indicated that their valuation risk assessment has some sort of risk rating (29%), heat map format (18%), numerical scoring (10%), or combination of the above (20%). How this information will be used and whether the process will resemble how other non-valuation risks are measured and tracked is uncertain. Twenty-three percent indicated that they are not sure how they will assess changes in valuation risk, and 59% indicated that they will focus on changes in portfolio attributes, such as new investment types and strategies, employing more of a qualitative approach than quantitative approach.

And that is really the story with the risk assessment process. Yes, fund groups have identified risks and assessed them to comply with the Rule, but whether there ends up being some really tangible result from the exercise that is helpful to the business is uncertain. For example, a key component of a meaningful risk assessment might also include identifying specific procedures designed to help assess and manage the risk. Forty-three percent of FV survey participants indicated that they have identified and mapped such procedures, but another 39% indicated that they have not mapped specific procedures to risks. The result of not doing so could be the performance of procedures that do not manage key risks and/or are unnecessary. Of course, mapping does not mean that all risk will be managed; rather, it is part of a robust risk management framework.

Ultimately, fund groups must each determine whether and how they can bring about a dynamic process that improves the valuation operating model over time. The more the assessment is updated in real time and the more integrated it is with the activities of the risk management, valuation, and compliance functions, perhaps the greater the likelihood that the risk assessment provides value beyond strictly Rule compliance.

Procedural changes surface relative to testing methodologies and overseeing pricing vendors

Rule 2a-5 requires that fund groups test fair value methodologies, and 19% of FV survey participants have added new procedures to test them. This is an area where we noted distinct differences based on the fund group's size, as those fund groups with more than $100 billion were more likely to have implemented more procedures compared to fund groups smaller than that (32% compared to 8%).

Since the vast majority of investments held by mutual funds are valued by pricing vendors, the FV survey sought to understand how valuation designees are meeting the Rule 2a-5 requirement to periodically review the appropriateness and accuracy of the methodologies selected. While nearly all FV survey participants obtain methodology documents provided by pricing vendors to support this requirement, most supplement this by performing additional analysis. Forty percent of FV survey participants review in great detail the methodologies for their full population of investments, whereas 57% are doing so for a sample set of securities.

The Rule requires an evaluation of pricing services. Although this concept is not novel by any means, the FV survey has identified several changes in the way fund groups will perform their oversight, and these are highlighted in figure 6—many relating to due diligence.

There may be a variety of ways to conduct this due diligence, and some of it is through documentation generated and produced by pricing vendors. Some FV survey participants appear to be conducting more virtual or in-person pricing vendor meetings. The end result is that 75% of FV participants now indicate that they visit all primary vendors annually, and 51% conduct annual visits for all secondary vendors.

Additionally, 17% added new procedures to enhance the process for challenging prices provided by pricing vendors as a result of adopting Rule 2a-5 to aid in consistency, to reduce the potential for bias, to promote effectiveness, and to enhance documentation.

Figure 6. How has your pricing vendor due diligence program changed under Rule 2a-5?

	Percentage reporting change
Increased focus on vendor documentation of back-testing performed	60%
Developed standard vendor due diligence questionnaire to be used for primary, secondary, and tertiary vendors	30%
Identified specific risks (excluding conflicts of interest) relative to the pricing vendors	27%
More frequent primary vendor due diligence meetings (e.g., moved to quarterly from annual)	18%
Identified one or more conflicts of interest relative to the pricing vendors	17%
More frequent secondary/tertiary vendor due diligence meetings (e.g., moved to annual from ad hoc)	12%

An emerging trend noted in the FV survey is the increased use of specialists. Eight percent of FV participants indicated that they engaged a third-party consultant to provide observations and recommendation regarding their valuation policies and procedures, valuation operating model and/or board oversight process compared to 1% in the prior year. A more significant maturing trend is the use of a third-party consultant to assist in the valuation process itself whereby 31%, up from 23% in the prior year, use a valuation specialist that periodically provides an independent valuation of one or more of its holdings.

Rule 2a-5 serves as a catalyst for continued technology advancement

FV survey participants have been using various types of technologies to improve the efficiency and effectiveness of the valuation operating model, and innovation continued again this year, as 65% of FV survey participants indicated that they made technological advancements in at least some area relative to valuation. Twenty-eight percent of FV survey participants indicated that some of these changes were directly the result of Rule 2a-5. While not limited to large fund groups, 75% of FV survey participants with more than $500 billion in assets under management made technology changes as a result of Rule 2a-5. Some FV survey participants noted improvements in data warehousing and a variety of board-reporting activities.

Figure 7 describes the type of technologies that funds groups currently used. The use of data visualization, in particular, is an emerging trend for many businesses, and such is also true relative to the valuation operating model, as fund groups continue to explore how visualization can make oversight more effective and efficient. Twenty-two percent of FV survey participants indicated that they implemented new visualization or increased the usage of visualization, compared to 9% who did so last year. FV survey participants who implemented or increased the usage of visualization reported the uses in figure 8, many of which have likely moved away from solely providing granular detail. Other technology solutions also saw increases year over year. These included: workflow management tools 19% (up from 11%) in the prior year, data analytics at 21% (up from 15%), and the use of software programming languages such as Python at 11% in the current year.

The desire to use technological solutions to enhance board reporting, whether for Rule 2a-5 or for other purposes, is not limited to the use of data visualization, as some FV survey participants also reported using data analytics and robotics process automation (RPA) to assist with board reporting. In fact, use of RPA to generate daily pricing exceptions reports increased to 65% from 39% the previous years. Generating back-testing reports increased to 35% from 11%.

The use of technology to help comply with Rule 2a-5 was not necessarily an expected result, but it's not a complete surprise. Fund groups with the regulatory ready discipline often confront regulatory challenges at hand by looking for new ways to improve the overall operating environment versus implementing the bare minimum to comply with rules. Technology enhancements, such as those related to data warehousing, RPA, data analytics and workflow management tools, have the potential to increase capabilities broader than just Rule 2a-5. As an example, with 34% of FV participants expecting more than half of their valuation resources to work on a remote basis, workflow management tools can be critical in making sure all approvals and reviews are properly performed on a timely basis, strengthening the controls and resiliency of the valuation operating model.

Figure 7. Types of technologies being used in the valuation operating model

Purpose	Percentage using it for the specific purpose
Excel tools (macros/queries/pivot tables)	97%
Data analytics	38%
Data management/data lake for valuation data	34%
Workflow management tools	29%
Data visualization	28%
Robotics process automation	19%
Software programming languages	11%

Figure 8. Reason for using visualization

Purpose	Percentage using it for the specific purpose
Board valuation reporting	81%
For periodic analysis and management/reporting (non-board-related)	62%
For back-testing analysis and reporting	52%
For daily pricing exception reporting	14%

Additional key FV survey findings

The FV survey contained questions on many subjects. Other key FV survey findings are shown below.

Future of work

- Thirty-four percent of FV survey participants expect that more than half of their valuation resources will continue to work remotely, including 10% that will work 100% in a remote setting.

- In 2020, in-person board meetings came to a halt. While some fund groups have begun to host in-person board meetings, 36% of FV survey participants are planning a mix of “in-person” and virtual board meetings are not planning to meet 100% in person in the future (subject to continued SEC flexibility). Fifty-three percent indicated that they planned to resume their previous practice such that the pandemic would have no lingering impact.

- 53% of FV survey participants are only conducting due diligence visits of pricing vendors virtually, while 45% indicated that they conduct some virtually and some in-person depending on the pricing vendor.

Russian invasion of Ukraine

- Forty-nine percent of FV survey participants securities affected by the Russian invasion indicated that they would have reported to the board the effect of valuation under Rule 2a-5’s “prompt” reporting requirement, subject to meeting materiality thresholds, while 25% indicated that they would have reported to the board the effect of valuation under the quarterly board reporting requirement.

- Eleven percent of FV survey participants indicated that, as a result of the difficulties accessing the Russian equity market after its invasion of Ukraine and the troubles experienced in valuing certain stocks, bonds, and financial instruments of that region, their approach to planning for contingencies changed should the primary valuation source not be available. For example, 6% have created or altered the hierarchy of options for valuing investments.

- Sixty-four percent of FV survey participants holding Russian rubles indicated that they are valuing them using current foreign exchange rates, whereas 27% indicated that they are valuing the Russian rubles at zero, essentially concluding that they are worthless.

Foreign equities

- Sixty-two percent of FV survey participants reported using a zero trigger to determine when to adjust the prices of fair value equities that trade on foreign exchanges closing before 4 p.m. ET, compared with 61% last year.

- Fifty-one percent of FV survey participants with both mutual funds and ETFs under management reported that their procedures for determining whether a foreign equity price should be adjusted from its closing exchange price are at least somewhat different between their mutual funds and ETFs.

Fixed-income securities

- Fifty-nine percent of FV survey participants use bid pricing exclusively when valuing fixed-income securities, nearly unchanged from the prior year, and 31% use mean pricing.

- Eighty-four percent of FV survey participants have valued fixed-income investments using a price adjusted to reach 4 p.m. ET, an increase from the 79% reporting it last year, and the highest percentage in the FV survey results since asking this question.

- Only two FV survey participants changed their valuation policies or procedures relating to non-institutional-sized lots (odd lots).

Private equity investments

- The concept of calibrating models to a recent transaction price was mentioned more than ten times in the adopting release of Rule 2a-5, and some FV survey participants seemed to have responded to this, as 50% of FV 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 last year.

Liquidity

- For a handful of years, the intersection of liquidity and valuation was a topic of interest, and management and boards contemplated how to consider it in performing their respective duties. While liquidity can be an indicator of the level of difficulty or risk associated with valuing an investment, it seems that most boards have not found sufficient correlation in understanding the liquidity of investments for purposes of performing valuation oversight, as only 22% of FV survey participants indicated that their boards consider it, easily the lowest percentage observed in the last five surveys.

Talent

- Twenty-one percent of FV survey participants changed the constituency of management's valuation committee. Some of these changes are related to the desire to reduce the potential conflict of interest when a portfolio manager is involved in the valuation process based on the requirements of Rule 2a-5.

- Twenty percent of FV survey participants made changes to their current financial resources, technology, staff, and expertise of the valuation designee, based on the requirements of Rule 2a-5, and 25% anticipated making such changes in the future.

- Six percent of those making changes indicated their reason was related to staff resources, and the remaining indicated that it was related to technology.

- Forty-nine percent of the fund groups had five or fewer valuation full-time equivalents supporting the valuation function, and 30% had 5-10 full-time equivalents.

SEC exams

- Although only 15% of FV survey participants were visited by the SEC's Division of Examinations, it is interesting that in 67% of such visits, the Division of Examinations did not focus on valuation, as compared to 42% in the prior year.

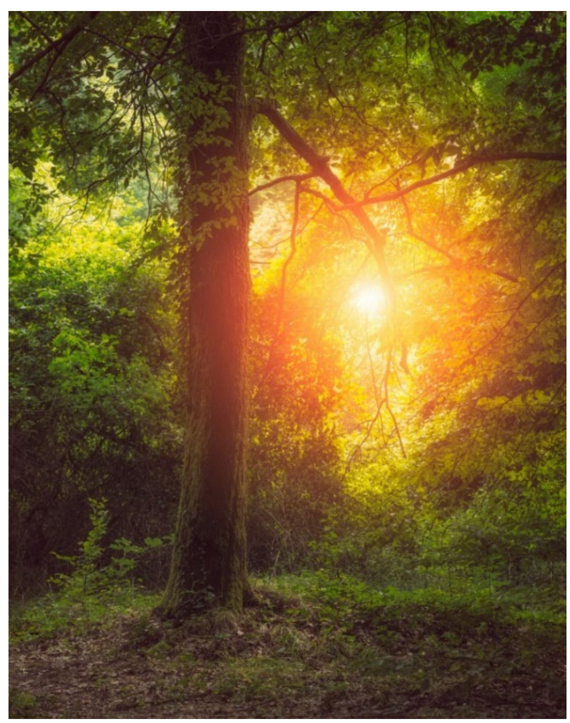
Cross trades

- Fifty-four percent of FV survey participants indicated that the SEC's Rule 2a-5, including the elimination of cross trades for level 2 and level 3 securities, would have the most impact on the fund industry's valuation process. Rule 2a-5 significantly reduced cross trades beyond those identified as Level 1 under US GAAP, a practice that benefited mutual fund shareholders, due to lower transaction costs.

- More than 50% of the FV survey participants engage in cross trading. Today, 12% classify treasury securities as Level 1.

Digital assets/Cryptocurrencies

- When asked how closely fund groups were following the evolution of digital assets/cryptocurrencies, only 5% indicated that they were actively involved in the space and investing in technology to incorporate digital assets into their fund group. Fourteen percent said they were closely monitoring and would consider launching new products if permitted by the SEC, and 28% said they were closely monitoring but not interested as this time.



Looking ahead

A warning: Discipline required for active oversight with a prescriptive' rule

The industry mostly embraced the SEC's first significant valuation guidance in over fifty years. Why not? It confirmed a long-standing industry practice of delegating the day-to-day execution of the valuation policies and procedures to management via the option to delegate to a valuation designee. It also clarified many responsibilities that mutual fund directors and the valuation designee must comply with if such an election is made. What is not to like? Well, the risk may be in the prescriptive nature of the Rule. While the twenty editions of the FV survey have shown constant attention, improvement, time, and governance over valuation policies and procedures, as well as the valuation operating model, pivoting to the Rule may dampen the collaborative and innovative relationship that we have noted in the FV survey between management and the board. Will this be lost? Will all eyes be on complying with Rule 2a-5? Will the SEC's goal of active oversight get lost in the required prompt, quarterly and annual reporting that the Rule requires? Will a trend emerge that the valuation designee and management have all of the risks covered and will only report to the board when something has gone wrong? Maybe September 2022 is too early to worry about such things, but we have all experienced prescriptive, compliance checklists that seemed robust but failed to surface an important issue of fact, resulting in an important action not being taken. Fund groups must stay diligent and maintain discipline to work with boards to keep clear, concise, and robust communications in place regardless of whether a report is due. Such collaboration and getting the right decision-makers at the table when price uncertainty arises has been a hallmark of the valuation operating model and should never be taken for granted.

Continued Rule adoption benefits

The Rule 2a-5 compliance date has come, and fund groups made significant efforts to comply. However, the question has never been whether fund groups would be able to comply. The real curiosity is whether there can be any measurable value derived from the Rule. As noted earlier, the adopting release of Rule 2a-5 listed potential benefits of the Rule. Those included items such as less biased valuations, more risk-based "active" board oversight, and even better portfolio management as a result. Those may be lofty goals that may not be completely achievable. However, there may be some ways fund groups can make Rule 2a-5 a winning endeavor for all stakeholders.

The benefits may start simply. Fifteen percent of FV survey participants indicated that there were a few areas, mainly relating to a reduction of materials they were providing to the board, in which they saved time. Some others reported that technology enhancements have made a difference.

With a focus on risk, the Rule's design certainly promotes creating an environment where procedures performed, not only by management, but also by boards are risk-focused, including risk-based reporting. As is the case with any new regulation, attention is placed on trying to meet the requirements of the Rule. In the following years, often other benefits can be achieved. Based on the adopting release of the Rule, fund groups may have a reasonable basis to conclude that they may be able to replace certain procedures because they do not really address identified risks squarely or because automation might make them irrelevant. Incremental gains can make the valuation operating model more resilient, which will be critical as employees continue to work for home for an extended period of time.

Convergence of industry valuation practices

As noted throughout the FV survey, fund groups choose their own paths forward. Albeit these choices along the adoption journey may not be significant, if the full view of a well-thought-out valuation operating model achieves the same outcomes, there may be regulatory risk that exists to those fund groups inspected in 2022 and 2023 (the early exams). The history of the FV survey has taught us that some emerging trends become maturing trends and finally develop into stabilized industry practices. However, the regulatory risk does lurk during the transition. Thus, benchmarking to identify differences across fund groups relative to Rule 2a-5 related matters will be critical. This sort of exercise may be something that many undertake to fine-tune their valuation policies and procedures as well as their valuation operating models. Some changes may also come about naturally as fund groups and their boards identify tasks and reporting that lack meaningful substance or fail to achieve desired results. They may also simply develop certain preferences that may result in the evolution of their valuation operating models.

The continuing role of technology

There were perhaps big dreams at one point of the role of artificial intelligence and machine learning in many aspects of the business world, and the valuation operating and oversight models were not immune to that kind of thinking. What the FV survey has shown is that some of the initial headline grabbers, to date, have not been suited to enhance such models, but that other technological enhancements have been made, contributing to real-time gains and overall resiliency of the valuation operating and oversight models.

FV survey participants continue to increasingly use technological solutions. With continued exploration of how to use data visualization, workflow tools, and RPA, there appears to be more opportunity to reduce the level of detail consumed by those overseeing the valuation function on a daily or periodic basis. The use of graphical depictions, backed by underlying data, may replace time previously spent to generate detailed reporting that required time to evaluate, to assess for accuracy, and to use for decision-making. Also, workflow tools and RPA may enhance the resilience of the valuation operating model and provide additional and needed controls over the valuation process in an extended remote work environment.

Contingency planning is evergreen

As noted earlier, a small percentage of FV survey participants have made changes to their contingency planning as a result of Russia's invasion of Ukraine. Fund groups working with industry associations were able to share information and experiences that better allowed them to reach conclusions on how to value securities in countries like Russia, Ukraine, and Belarus, but it was by no means an easy process. There remains an opportunity to consider whether a "Plan B" can be created for other scenarios that might affect a fund group's holdings, and whether such plan can be sufficiently tested in advance of an event. Often such a plan can include having internal models or a valuation specialist at the ready to support valuation where price uncertainty enters the markets. On the more aggressive end of Plan B, fund groups are looking to establish a "shadow" NAV full playbook and replicate a daily NAV process. Although merely a proposal at this stage, the SEC proposed a cybersecurity rule[2] suggesting that this be a requirement of all fund groups and the mutual fund industry. Whatever direction a fund group takes to tackle Plan B, it will be an imperative to work close with risk management and/or the risk committee to anticipate what is around the corner and be "on the ready" to take action should valuation challenges arise.

An opportunity with private equity valuation

With more than 50% of FV survey participant fund groups investing in private equities, such investments continue to be the source of significant valuation time and resources as well as governance oversight. However, one interesting trend in the FV survey is how little change there has been in the valuation itself of private equities, at least based on the FV survey results. While "no change" is not necessarily bad, one of the greatest challenges is the availability of information that makes real-time, daily analysis sometimes difficult. A slightly increasing percentage of FV survey participants (from 23% in the prior year to 31% in the current year) employ a valuation specialist to assist with valuing the investment type, and that may represent an emerging trend, but there may be an opportunity to tackle the challenge relating to the availability of information. It may be worth exploring whether technological advancements could aid in the collection of data of portfolio companies and whether such data can be woven with available real-time public information to achieve more current valuations that are perhaps slightly less dependent on judgment and may be less subject to bias, meeting an objective of Rule 2a-5.

This may seem like a dream, but many dreams are achievable when we take a step ahead in order to find a new path forward.

Endnotes

1. Securities and Exchange Commission (SEC), Final Rule 2a-5 – *Good Faith Determinations of Fair Value*, December 3, 2020.
2. SEC, "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies," February 9, 2022.

About the FV survey and its authors

We conducted the FV survey in summer 2022, and participants representing 90 registered investment company fund groups completed it. FV survey participants included small, midsize, and large fund groups. Thirty-four percent of them had more than 100 funds within the fund group, and 22% had less than 15 funds. Approximately 11% of them managed mainly equities, 7% managed mainly fixed-income securities, and the remainder managed a balanced array of strategies. Percentages reported are generally based on the number of survey participants responding to the specific question, unless otherwise noted.

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