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Fair valuation pricing survey, 21st edition

Answering the bell: Responding to new requirements

Executive summary

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Answering the bell: Investment companies adopt Rule 2a-5 and enhance their valuation operating model

As our Fair Valuation Pricing Survey enters its third decade, it is clear that interest in valuation policies, practices and the valuation operating model has never been higher. With an all-time record of 104 fund groups participating in the survey, the industry has spoken—valuation is top of mind and understanding valuation risks and the valuation operating model are important. Should we be surprised?

With the one-year anniversary of the adoption of the U.S. Securities and Exchange Commission's ("SEC") rule 2a-5 ("Rule 2a-5" or the "Rule") of the Investment Company Act of 1940 (the "Act") still in the rearview mirror, the potential for SEC examination of compliance with the Rule, and the desire for continuous improvement, we would respond with a resounding "NO". Knowledge, data, and information are key, and the ability to have the most recent trends and practices during times of transition and SEC scrutiny is critical. It should also come as no surprise that the two times the number of survey participants exceeded 100 fund groups were also during times of transition and change. The first time was in 2015, our 13th edition of the Fair Value Pricing Survey. Around this time in July 2014, the SEC included unexpected valuation guidance in the Money Fund Rule and then later in the year clarified fund director expectations by way of the publishing frequently asked questions (FAQs) surrounding fair valuation and the Money Fund Rule. At the time, there was keen interest in how fund groups would collaborate with their fund directors to comply with what seemed to be overreaching responsibilities. The second time is entrenched in all of our memories, as it was 2020 and our 18th edition of the Fair Valuation Pricing Survey. As highlighted in the executive summary that year—"Valuation processes put to the test"—it was another time of change and valuation challenges as valuation policies and procedures and the valuation operating model faced a number of headwinds created by the global pandemic, including a 100% move to a fully remote work environment, extreme market volatility, and government intervention in the economy and markets. Obviously, nothing will compare to the human, emotional toll of the global pandemic.

As we break down the 21st edition of the Deloitte Fair Valuation Pricing Survey (the "FV survey"), we have kept an eye on Rule 2a-5's impact on the valuation operating model as the adoption of Rule 2a-5 represented the SECs most concrete and encompassing rulemaking on investment valuation for registered investment companies and business development companies ("fund groups") that it had produced in more than 50 years. Also, as history has told us, there likely will be high interest in understanding how Rule 2a-5 was adopted and implemented by fund groups as we pass its one-year anniversary. The FV survey results provide a lens into how fund groups responded to the Rule as well as other valuation challenges, showing emerging, maturing, and industry trends and practices relating to governance, risk management, technology, and the valuation of foreign equities, private equities, and other asset classes.

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Rule 2a-5 and the adequacy of resources

Regardless of the specific rule, the journey towards compliance always has one thing in common: it takes people to make compliance a reality. A strong valuation operating model is supported by the collective experiences and judgment of the people who drive the day-to-day activities within it, and Rule 2a-5 recognizes this by requiring valuation designees to annually report to their respective fund group's board of directors/trustees (the "Board") on the adequacy of valuation resources.

The Rule neither provides clarity on how the valuation designee should perform such assessment nor how the Board should assess its adequacy. It also does not provide context as to what would be "normal or sufficient" in terms of the level or experience of resources. The FV survey results illustrate just how difficult it is to define this, as only 9% of FV survey participants indicated that they had established with the Board sets of criteria or metrics to aid in evaluating the adequacy of valuation resources. Amongst the 9%, one FV survey participant highlighted that they had developed metrics associated with pricing vendors, one of the pricing data resources available to fund groups. A couple of other FV survey participants pointed to the fund group's own personnel, including an analysis of experience levels and a full-time equivalent ("FTE") analysis.

FTE-based metrics are an interesting idea. It is certainly challenging to define how many valuation-focused FTEs that a fund group should have, and it is even perhaps more difficult for Board members to assess the accuracy and adequacy of a valuation designee's report using only their own instincts, experience, and educated judgment based on the fund lineup and types of investments held. Currently, there is not much in the way of published data to aid in this analysis, so this is not an easily accomplished task.

The FV survey offers data points based on the size of fund groups as to what might be typical, acknowledging that a smaller-sized fund group with many private equity positions might require more resources than a larger-sized fund group holding only exchange-traded equities. As noted in Figure 1, the majority (86%) of fund groups with less than $10 billion in assets under management ("AUM") reported that they had less than five valuation-focused FTEs, whereas the majority (69%) of fund groups with greater than $500 billion in assets under management had 10 or more valuation-focused FTEs.

In general, most fund groups reported employing fewer than 10 valuation-focused FTEs.

In addition to the commonality of size, all the fund groups reporting the use of more than 15 FTEs held fixed-income investments, many also held private credit investments, nearly all held private equities, most of which was acquired through actively seeking such investments, and most had actively managed exchange-traded funds ("ETFs"). In contrast, those with fewer than five FTEs were much less likely to hold private equities (40%) or private credit investments (12%), and most did not manage ETFs (fewer than 33% did).

Figure 1. Full-time equivalents based on size of fund group

AUM in billions	Fewer than 5 FTEs	5 or more but fewer than 10 FTEs	10-15 FTEs	More than 15 FTEs
Greater than $500	8%	23%	8%	61%
$101-500	45%	36%	14%	5%
$51-100	47%	47%	6%	0%
$10-50	74%	20%	3%	3%
Less than $10	86%	9%	0%	5%

Determining where valuation resources should reside is another data point. Offshore resources (excluding those that may be employed by the fund accountant) are used by 17% of FV survey participants (including 54% of those with AUM in excess of $500 billion) for tasks including daily price checks, escalation of price exceptions, and monthly reporting, which may provide not only a deeper pool of resources but also may be part of a business continuity strategy.

The use of external valuation specialists can be helpful, especially for less liquid and/or restricted asset classes, but it can complicate the evaluation of, comparison of, and reporting of the adequacy of valuation resources. The FV survey found that 54% of FV survey participants holding private equity investments use a third-party specialist to assist in the valuation of at least some of their private equity holdings, most commonly as the primary valuation source for one or more positions. In the 20th and 19th editions, 31% and 23% reported the use of a third-party specialist to value these investments, respectively, showing continued growth each year.

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Finally, for many fund groups, having a point person to lead the valuation function is essential. More than 80% of those reporting having AUM greater than $100 billion have appointed an employee who has the specific responsibility to manage and oversee the fund group's entire valuation operating model (i.e., a Head of Valuation). Just under half of fund groups with less than $10 billion in AUM reported having a similar role.

Those responsible for valuation, as well as those who assist them, have had a tall task with many headwinds affecting valuation. Examples include the adoption of Rule 2a-5 and its impact on board reporting and risk assessment, the drive for improved effectiveness and efficiency through technological change, and a variety of specific valuation tactical matters. The FV survey results illustrate that fund groups continue to respond to each area of need to keep the valuation operating model running in a reliable and resilient manner. However, although there are many commonalities in valuation practices, each fund group in the FV survey has handcrafted their own valuation operating model considering the composition of their portfolios, their resources, and their preferences, many of which have been shaped by discussions between investment advisers and Boards as well as their valuation experiences. The response to Rule 2a-5 provides yet another example of just that.

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Rule 2a-5 formalizes Board reporting

In the same breath, Rule 2a-5 is both prescriptive and not prescriptive. Its quarterly and annual reporting requirements require scheduled reporting of specified items, but how valuation designees perform that analysis and how boards carry out their oversight responsibilities is fairly judgmental. The adopting release[1] of the Rule highlights that:

"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."

Boards who have appointed a valuation designee are receiving required reporting that address the elements described in the passage above. However, Rule 2a-5 allows each Board the flexibility to determine other reporting that they would like to receive in carrying out its active oversight duties relating to valuation. The FV survey results suggest that some Boards may be redefining what valuation oversight really means, especially as it relates to their involvement in certain activities and the level of detail they receive, potentially to help them be more objective and to improve their ability to be skeptical. Changes noted within the FV survey include the following:

- Thirty-four percent of FV survey participants indicated that over the last year the Board had delegated more responsibilities to management, up from just 10% noting such last year.
- The Board's formal ratification or approval of certain non-vendor-priced investment valuations, valuation policies and procedures, and the use of pricing vendors was once extremely common, but as Figure 2 illustrates, these have declined substantially as Boards more commonly are focusing on oversight of the process.
- On the whole, the use of summarized Board reporting continues to represent a sustained trend, with nearly 100% reporting that they provide their Boards with summarized reporting (sometimes in the form of a dashboard and sometimes in another form). For certain areas, summarized reporting has become sufficient on its own, replacing the need for more detailed analysis, as only 18% of FV survey participants indicated that their Boards require full detailed reports to support all summarized reporting.

Figure 2. Ratification/approval

Area	Percentage that ratify/approve – 21st edition	Percentage that ratify/approve – 16th edition
All or certain valuations determined by parties other than pricing vendors	17%	52%*
Another party's periodic review of valuation policies and procedures	62%	86%
Another party's periodic evaluation of pricing vendors	41%	77%

**Statistic excluded both pricing vendors and brokers in the 16th edition.*

Board reporting itself is clearly an area of deep interest to FV survey participants and their Boards. Although many FV survey participants worked with Boards prior to Rule 2a-5's compliance date to reconsider and determine reporting that Boards would find most helpful, doing so did not necessarily result in Board reporting being locked down. On the contrary, 52% of FV survey participants noted that they changed certain aspects of Board reporting over the last year based on requests by the Board. Some Boards wanted more detail (13% of those), and some wanted less (10% of those). Twenty-seven percent of FV survey participant indicated that there was a change in the format of materials, such as adding or changing valuation dashboards.

The use of dashboard reporting is a subject that the FV survey has studied for many years. Many Boards use them, but their popularity has not grown to be more widespread, with 47% of FV survey participants reporting this year that they provide them to their Boards, unchanged from last year and nearly identical to the 46% reporting such in each of the two prior years.
However, the static nature of that statistic does not tell the entire story, as those who have been using dashboards seem to have either changed or expanded their use. For example, 19% of FV survey participants noted that they created additional dashboard reports, presumably to promote more visual snapshots of key valuation indicators ("KVIs") and to better illustrate trending. There has also been some movement in the key valuation indicators appearing on dashboards. The most common key valuation indicators are listed in Figure 3.

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Figure 3. Most common KVIs on dashboards

KVIs	21st edition	20th edition
Percentage of Level 3* investments	90%	71%
Number of price challenges	85%	74%
Back-testing results of trades	79%	86%
Unchanged (stale) prices	75%	76%
Back-testing results of foreign equity fair value factors	67%	71%

**As defined in US GAAP, Accounting Standards Codification 820.*

In general, Rule 2a-5's more noticeable impact on Board oversight indeed appears to be on Board reporting. Overall, 54% of FV survey participants indicated that their Boards are now receiving more valuation materials than they did in the past, up from just 16% reporting such last year. This increase relates mainly to the discretionary reporting not prescribed specifically by Rule 2a-5.

When it comes to required reporting, 33% of FV survey participants noted that they reported matters under the prompt notification provision to the Board in the first year of the Rule. The prompt notification aspect of the Rule requires that the valuation designee provide a written notification of the occurrence of matters that materially affected the fair value of the designated portfolio of investments within a time period determined by the Board, but in no event later than five business days after the valuation designee becomes aware of the material matter.

In addition, 34% of FV survey participants have had detailed conversations with the Board to understand their prompt notification expectations to reduce the risk of underreporting and confusion/uncertainty as to next steps once the designee has identified a potential matter.

The valuation designee is also required to report certain material items quarterly and certain other items annually, but Rule 2a-5 allows for individual determinations of what is material. Many FV survey participants seemed to have followed suit, establishing the reporting cadence as required, but the majority (more than 70%) did not set specific criteria for determining each of the following:

- Determining what constitutes a material change to the valuation designee's process for selecting and overseeing pricing services;
- Determining what represents a material change in conflicts of interest;
- Identifying material events related to the valuation designee's oversight of pricing services; and
- Identifying material changes to the roles or functions of the persons responsible for the valuation process.

As with many of the determinations within Rule 2a-5, these are judgment items, and there may not be a universal way for a valuation designee to apply them, leaving room for diversity in practice across fund groups.

Fundamentally, one might reasonably conclude that a new rule directly affecting reporting matters to the Board would likely result in a greater percentage of the Board's agenda being devoted to valuation, but the bottom line is that this does not necessarily appear to have been true for all Boards. Although 34% reported that the time spent by the Board had increased, 11% indicated that it had decreased. That may seem like a relatively low percentage but considering that the highest percentage reporting such in any of the last five years was 4%, this is a noteworthy development that may signify that the Rule's focus on more risk-driven governance may eventually result in a shifting of Board time away from valuation and to other matters requiring the Board's attention.

Further to this point, we continue to track three tools that Boards have at their disposal to aid in and demonstrate "active" oversight:

1) Ad-hoc valuation meetings.

2) Specific valuation policies and procedures that address when the Board "must be involved" or "must be notified" to discuss a valuation matter.

3) Board reporting.

Here we see similar emerging trends regarding ad-hoc meetings. For example, ad-hoc meetings at which a valuation matter outside the scheduled board meeting cadence is discussed with the Board showed a significant drop from 39% of FV survey participants in the 20th edition of our FV Survey to 20% in our current FV survey. In addition, relating to the Board oversight tool where fund groups have established up-front scenarios whereby the valuation policies and procedures identify specific circumstances under which the Board "must be involved" or "must be notified", the FV Survey showed a drop from 8% to 5% in the "must be involved" circumstances and a very slight decrease from 34% to 33% as to the "must be notified" circumstances. Certainly, an emerging trend worth watching, as it seems like the Rule's prescriptive reporting requirements (prompt, quarterly, and annual) may be stemming some of the robust, free-flowing conversations and expectations from past years.

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Valuation practices evolving under Rule 2a-5

The adopting release[2] of the Rule stated a rather lofty objective when it suggested that the Rule could result in more accurate fair value determinations, as illustrated below.

"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."

No one would argue with a goal of achieving more accurate fair valuations, but whether that is achievable as a result of the Rule and even measurable may never be fully known. The prescriptive aspects of the Rule attempt to lay the groundwork for enhanced oversight by requiring a risk assessment focused on matters that may compromise the accuracy and integrity of the fair value determination process, whether due to the scarcity of information, the complexity of a calculation, or a conflict of interest, by coupling that risk assessment with procedures designed to test the accuracy of the valuation methodologies.

Nothing happens overnight, and 65% of FV survey participants indicated that the implementation of Rule 2a-5 required a moderate level of time, expense, and resources to comply with it, including the risk assessment and testing fair value methodologies aspects of the Rule.

Risk assessment trends

The valuation risk assessment process was still a work-in process when we conducted last year's FV survey, and, as a result, this year's FV survey results show some slight changes in practices between years, most notably the following:

- Risk is commonly categorized by asset class (66%) and/ or by security type (60%), the latter of which grew considerably from the percentage reported in the prior year (44%), while the former was up slightly from 60%.
- Seventy percent of FV survey participants added that, as part of their Rule 2a-5 risk assessment, they identified and documented the risk associated with key inputs and assumptions specific to each asset class or portfolio holding and the appropriate application of fair value methodologies, up from 55% reporting such in the prior year and 32% two years ago.

Thirteen percent of FV survey participants have added new risks within their risk assessment since the adoption of the Rule. Examples of new risks identified included bank sector failure, counterparty risk, insufficiency of resources, and the risk of manual processes/lack of automation for back-testing, data maintenance, and reporting.

One might reasonably believe that if a proper risk assessment is truly a necessary step in achieving better fair values, that such assessment would be very granular and very specific in order to pinpoint areas of risk and to develop tailored procedures designed to address them. However, while some FV survey participants have identified risks for each asset class, as noted previously, the risks that are more broadly applicable tend to be fewer in nature, as exemplified by the following:

- Eighty-one percent of FV survey participants have identified risks at a high level either within their policies and procedures or in a separate document.
- Fifty-two percent of FV survey participants described their risk assessment as containing a few high-level/general risks (five or fewer), and 20% of FV survey participants described their risk assessment as containing specific detailed risks encompassing and/or directly targeting all or nearly all asset classes.

Risk assessment is not a static area but rather a continuous, evergreen process. Still, it is quite possible that the performance of a risk assessment to comply with the Rule itself may not lead to better fair valuations. Instead, the day-to-day testing procedures performed by valuation team members may more quickly identify areas of risk real-time and may allow for responsible personnel to take more immediate steps.

Of course, some of the reason that risk assessments might not accomplish everything on their own may be unintended constraints suggested within the Rule itself. For example, an interesting aspect of the Rule relative to risk is its focus on the undefined term of a "material valuation risk". Many fund groups have concluded that this should be a quantitative measure, and 59% of FV survey participants indicated that a material valuation risk is a risk that, if not mitigated successfully, could result in a net asset per share ("NAV") error as defined by their policies and procedures. The focus on translating a risk into a quantitative amount is

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something seemingly easy to measure and understand, but it also may be difficult to evaluate how material each input into the determination of a position in an asset class level is relative to its impact on a fund's NAV. This may be part of the reason that many fund groups have identified higher-level risks.

Finally, 62% of FV survey participants indicated that they rate risks using scoring, heat maps or other means as part of their risk assessment, but the FV survey results did not reveal any significant increase in the desire for more scientific or formal risk ratings compared to the prior year.

Testing fair value methodologies trends
The big story in this area really relates to the due diligence process involving pricing vendors. Due diligence of pricing vendors has certainly changed as a result of Rule 2a-5, which is illustrated in Figure 4.

Figure 4. Areas in which pricing vendor due diligence has changed

Areas of change by fund groups:	Percentage reporting change
Increased focus on vendor documentation of back-testing performed	44%
Using new platforms and documentation that the pricing vendors are providing	43%
Developed standard vendor due diligence questionnaire to be used for primary, secondary, and tertiary vendors	29%
More frequent primary vendor due diligence meetings (e.g., moved to quarterly from annually)	19%
More frequent secondary/tertiary vendor due diligence meetings (e.g., moved to annually from ad hoc)	17%

Seventy-five percent of FV survey participants perform due diligence visits at least annually for all their pricing vendors that serve as a primary source, and 53% do so as well for the pricing vendors that serve as their secondary sources, compared to 75% and 51% in the prior year and 57% and 35% two years ago, respectively. This sustained change in due diligence visits over the past two years is likely attributable to the requirement under Rule 2a-5 to evaluate the fund group's pricing vendors. It may also partially be a result of the fact that a pricing vendor may serve as a primary source for some securities and a secondary source for others, illustrating a fund group's desire to find the best pricing source for each asset class or investment type.

The Board's involvement in pricing vendor due diligence has largely not changed as a result of Rule 2a-5, with just 3% percent indicating that there has been an increase in the Board's attendance at meetings with pricing vendors and 8% indicating that there has been a decrease. This finding seems to suggest that Boards do not feel that involvement in the due diligence process is a necessary part of valuation governance and that the prompt, quarterly, and annual reporting requirements along with other reporting is sufficient to support their goal of "active" oversight.

One thing that the FV survey did not illustrate was significant changes in testing approaches themselves. Just 16% of FV survey participants indicated that they have deployed new testing relating to evaluating fair valuation methodologies used by pricing vendors, most commonly related to testing prices against actual sales transaction prices (back-testing). While not a significant percentage, this finding does illustrate the willingness of fund groups to alter their historical testing approach to comply with the Rule.

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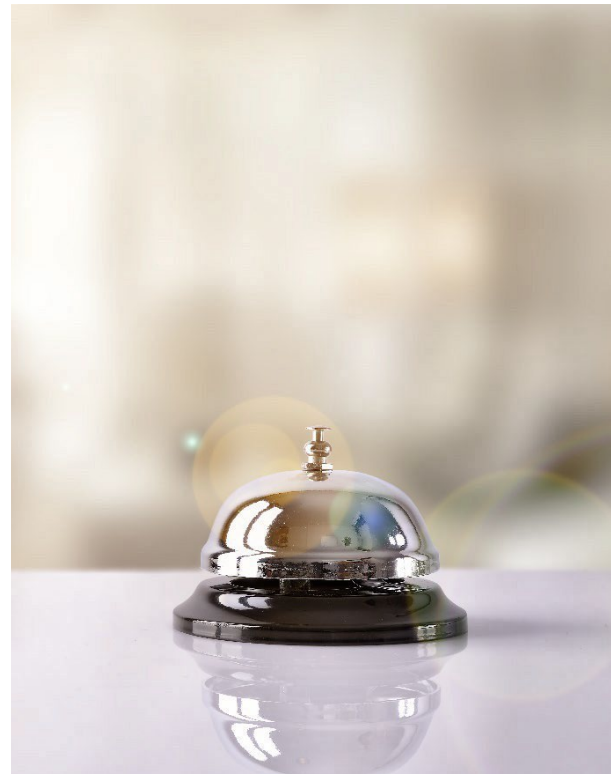

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Fund groups continue to invest resources in technology to strengthen the valuation operating model

FV survey results suggest that fund groups have not lost their zeal for enhancing the valuation operating model through technological advancements. Sixty-eight percent of FV survey participants reported that they had begun to use or increased their usage of different forms of technology for valuation purposes, as depicted in Figure 5. Last year, 65% reported that they had begun to use or increased their usage.

Although the largest fund groups (those with greater than $500 billion in AUM) clearly lead the movement at 92%, nearly 60% of those FV survey participants with less than $10 billion in AUM also indicated that they had begun to use or increased their usage of different forms of technology. Thus, both larger and smaller fund groups have been participating in enhancing their valuation operating models through technological enhancements.

For the most part, the FV survey seems to suggest that no single technology is the leader in the clubhouse from a growth perspective. Figure 6 illustrates the use year-over-year of each of the technologies (factoring in slight shifts because of changes in survey participants each year). Understanding that a commitment to technologies requires investment, resources, and time, the continuum of growth here continues to support this maturing trend.

The FV survey also illustrated that existing users appear to be driving the enhancement or expansion of their technological capabilities as opposed to fund groups using technologies they have not previously used. Figure 6 shows limited changes in the overall percentage of FV survey participants using each type of technology. Another item of note is that while FV survey participants of all sizes seem to use each form of technology listed in Figure 6, it is more the norm for the largest fund groups to use certain types, as the majority of fund groups with over $500 billion in AUM use data lake/data management, workflow, and data analytics tools, while only a minority of fund groups of smaller sizes do.

Figure 5. Areas in which the use of technology has changed

Technology	Percentage reporting change
Spreadsheet tools (i.e., macros/queries/pivot tables)	36%
Data analytics	23%
Data visualization tools	23%
Data management/data lake for valuation data	22%
Workflow management tools	17%
Robotics process automation	10%
Software programming language	10%

Figure 6. Technology in use

Technology	Percentage reporting use – 21st edition	Percentage reporting use – 20th edition	Percentage reporting use – 19th edition
Spreadsheet tools (i.e., macros/queries/pivot tables)	90%	97%	93%
Data analytics	36%	38%	36%
Data management/data lake for valuation data	34%	34%	34%
Data visualization tools	32%	28%	26%
Workflow management tools	27%	29%	35%
Robotic process automation	15%	19%	16%
Software programming language	14%	11%	Did not ask

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Technology can be and is being used by FV survey participants for a variety of purposes. For example, a couple of FV survey participants noted that they are using technology to better track or document fair value events. In addition, two FV survey participants indicated that they are using cognitive automation, natural language processing, machine learning, or artificial intelligence in their valuation operating model, one of which noted that the use was for performing advanced analytics. We have highlighted this because none of the FV survey participants had acknowledged successful use of such technology for valuation purposes during the previous five editions of the FV survey. Perhaps these and other advanced technologies are on the brink of disrupting today's valuation operating models.

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Additional key FV survey findings

The FV survey contains questions on many valuation topics, too numerous to capture all within this Executive Summary. Additional key FV survey findings, as determined by the survey authors, are highlighted below.

Virtual vs. in-person

- Seventeen percent of FV survey participants note that more than half of their valuation resources are working virtually, including 6% that work 100% in a remote setting. Forty-nine percent indicated that none of their valuation resources are currently working virtually on a full-time basis.

- As noted in prior surveys, the COVID-19 pandemic changed how Boards conducted meetings. Forty-nine percent of FV survey participants noted that Board meetings are now operating just as they did pre-pandemic, fairly consistent with the 53% reporting such last year. However, 34% of FV survey participants have scheduled a mix of in-person and virtual board meetings and are not planning to meet 100% in person in the near future (subject to continued SEC relief).

- Thirty-seven percent of FV survey participants, compared to 54% last year, are only conducting due diligence visits of pricing vendors virtually, while 58%, compared to 45% last year, indicated that they conduct a mix of virtual and in-person meetings at pricing vendors.

Board governance

- Thirty-six percent of fund groups indicated that the Board has a Risk Oversight Committee in place. This is an increase from 30% in the prior year and 28% two years ago.

Russian-based investments and currency

- Eighty-six percent of FV survey participants are valuing Russian-based local equities at zero, and 77% are valuing Russian-based depositary receipt equities at zero.

- Forty-six percent of FV survey participants holding Russian rubles indicated that they are valuing them using current foreign exchange rates, compared to 69% reporting such last year. The movement away from using the current rates has resulted in some FV survey participants (52%) reporting the Russian rubles at zero.

Foreign equities

- Sixty-three percent of FV survey participants reported using a zero trigger to determine when to adjust the prices of all or a subset of fair value equities that trade on all foreign exchanges closing before 4 p.m. Eastern Time (ET) versus 62% in the prior year's survey.

- Thirty-nine percent of FV survey participants managing actively managed ETFs receive and apply a standard factor provided by a pricing vendor if a certain trigger (zero, 50 basis points, 100 basis points, etc.) is met. The percentage was exactly the same for passively managed ETFs.

Fixed-income Investments

- Sixty-three percent of FV survey participants use bid pricing exclusively when valuing fixed-income securities (compared to 59% in prior year), 27% use mean pricing (compared to 30% in the prior year), and 10% reported that their use varies based on the type of fixed-income instrument (compared to 11% in the prior year).

- Specific to fixed-income ETFs, 48% reported using bid prices, 40% reported using mean prices, and 12% reported that the use varies.

- Eighty-four percent of FV survey participants have valued fixed-income investments using a price adjusted to reach 4 p.m. ET, unchanged from last year.

- Only one FV survey participant changed its valuation policies or procedures relating to non-institutional-sized lots (odd lots), compared to two in the prior year.

Private equity investments

- Fifty percent of fund groups indicated that they held private equites in their fund portfolios as compared to 52% in each of the two previous years.

- Sixty-five percent of FV survey participants indicated that a comparable companies' analysis is the most common way that they value the largest percentage of their private equity holdings.

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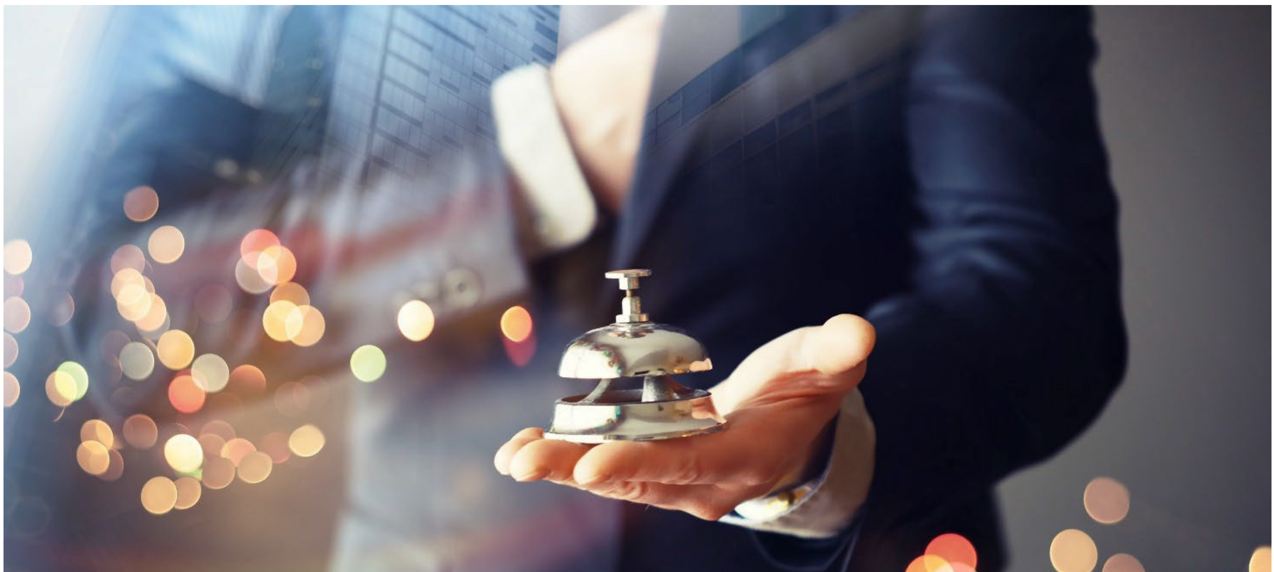
- Sixty percent of FV survey participants with investments in private equities indicated that they are maintaining internal documentation of their consideration of calibration for their investments, up from 50% reporting such last year and 34% reporting such two years ago.

SEC exams

- Despite the recent uptick in SEC activity focused on fund groups' compliance with rules and regulations, only 11% of FV survey participants were visited during the last year by the SEC's Division of Examinations, and half of those indicated that the examination included a focus on one or more aspects of valuation. We believe that regulatory examinations of compliance with Rule 2a-5 may increase and may continue into 2024.

Digital assets/cryptocurrencies

- When asked how closely fund groups had been following the evolution of digital assets/cryptocurrencies, only 8% indicated that they were actively involved in the space and investing in technology to incorporate digital assets into their fund group. Seven percent said they were closely monitoring and would consider launching new products if permitted by the SEC, and 36% said they were closely monitoring but not interested as this time.



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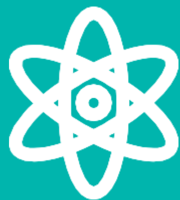
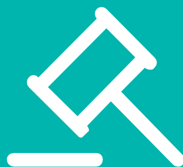
Looking ahead



The danger of autopilot

The very many editions of FV surveys have taught us that fund groups often make changes to their valuation policies, procedures, and valuation operating model each year, and we would not expect that to be any different going forward. In fact, 54% of FV Survey participants indicated that they changed their valuation policies and procedures subsequent to the adoption of Rule 2a-5. However, Rule 2a-5 is new, and in Year 2, it is possible that certain aspects of Rule compliance may become more steady state in approach. This may be acceptable as long as it is periodically re-evaluated and the communication between fund groups and Boards remain proactive and transparent. Rule 2a-5 came with a price tag – both in terms of dollars spent and time incurred. That price helped build a foundation as well as provided more certainty with regards to the roles and responsibilities over valuation oversight and execution. Benefits to be gained from Rule 2a-5 will likely come after the first year when compliance is still in its infancy and the newly implemented processes are still being learned. Any gains will likely be later. Because factors affecting fund groups continue to develop or change, the valuation process is naturally evergreen, which is why it is important to avoid any desire to go on autopilot but rather continue to look for ways to improve the valuation operating model.



Required prompt Board reporting tops the charts: Are there long-term implications for active oversight?

As the fund industry mostly embraced the SEC's first significant valuation guidance in more than 50 years, we are starting to see some emerging trends in Board reactions. This may not come as a surprise as the Rule reconfirmed 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. However, datapoints in the FV Survey in which there was an increase in Boards that spent less time on valuation as an agenda item and held fewer ad-hoc meetings to discuss a valuation matter real-time may be an aberration or it could be that the prescriptive nature of the Rule has reset the interaction and communication between fund groups and Boards. While our FV surveys 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 fund groups and Boards. A notable surprise to the industry was the frequency of the prompt notification reporting being required. As identified in a preceding section, approximately 30% of FV survey participants indicated that they reported valuation matters under the prompt notification provision to the Board in the first year of the Rule. Will this be a substitute for robust free-flowing conversations between fund groups and Boards? Fund groups and Boards 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 the benefits outlined within the adopting release of the Rule will be realized at some point. Those benefits included items such as less-biased valuations, more risk-based "active" Board oversight, and even better portfolio management as a result.

Putting those goals aside, there may be other benefits from the Rule. The Rule's requirement for a valuation risk assessment may lead some fund groups to change or replace certain procedures because they do not really address identified risks squarely or because automation might make them irrelevant. Incremental gains may make the valuation operating model more resilient.

SEC Alert: Convergence of industry valuation practices?

As noted throughout the FV survey, fund groups choose their own paths forward, and this was no different with the adoption of Rule 2a-5. The FV survey results show some diversity in the application of many Rule 2a-5 requirements, including the timing and extent of Board reporting, the involvement of Boards in certain matters, and how fund groups test fair value methodologies. Some of these differences may change over time based on regulatory feedback or the sharing of perspectives by industry participants.

Industry participants may find proactive benchmarking to identify differences across fund groups relative to Rule 2a-5-related matters to be especially helpful. 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.

Being mindful of conflicts of interest

Rule 2a-5 specifically cites conflicts of interest as being an important valuation risk. Being vigilant in looking for conflicts of interest is important for valuation designees and their Boards. Mitigating the risk associated with portfolio management's involvement in the valuation process remains important, but such may become more challenging for certain asset classes where public information associated with an investee is not readily available, making the valuations more dependent on data that front office personnel may provide. Sub-advisers may also play an assisting role in valuing certain asset-classes, and the consideration of the potential for conflicts of interest associated with them may also be prudent.

Dependence on data and technology

The creation of valuation dashboards, exception-based reporting, and reports featuring visualization share a common bond in that they are all dependent on the completeness and accuracy of the source data from where they originated and dependent on the technology used to generate them operating as designed. The failure of a technological application could render such reporting inappropriate, affecting both decision-making and oversight. Even certain valuations themselves could fall victim to such dependencies and risk. Although this is not a new risk, the focus on Rule 2a-5 and the presence of business imperatives and risks may continue to press the need for technological advances to balance the increased demand for specialized reports with limited personnel to generate

them. Remembering to schedule testing of applications may remain important to a successful valuation operating model. In addition, developing, implementing, and operating technology requires that a robust control environment exist, especially around data management.

The role of the external fund accountant

Fifty-eight percent and 54% of FV survey participants require or expect that their fund accountant will run their normal price tests and report back any exceptions on price overrides or other manual prices, respectively. A recent SEC administrative proceeding[3] against a fund administrator highlighted the role a third-party fund accountant can play in being an important gatekeeper. There may be either procedures or reporting that fund accountants can perform or provide that would aid in the detection of material errors, whether inadvertent or deliberate. In evaluating risk-mitigating procedures, fund management and Boards may wish to revisit their understanding of the role that the fund accountant plays in the internal controls of the fund group and assess whether there are changes that both parties would like to adopt that may be accretive to the success of the valuation operating model.

An opportunity with valuing less liquid positions

Many fund groups hold investments that are less liquid. Some positions are acquired directly, and some become illiquid as a result of corporate actions, restructurings, or regulatory actions. Valuing private equities, private credits, and halted/delisted securities remains a challenging area for fund groups, especially because there are neither quoted prices available nor a perfect way to develop fair values. Thus, it is no surprise that the FV survey shows a trend of fund groups using third-party valuation experts to value these types of instruments. As noted previously, the fund group is still responsible for providing the right and accurate data and inputs, and the environment must be well- controlled. In addition, oversight and responsibility of the process and outcomes cannot be left unattended.

In the spirit of Rule 2a-5, fund groups may wish to continue to evaluate their practices, including how their valuation approach conforms to the requirements of accounting literature and how fund groups institute a process that demonstrates their ability to develop unbiased valuations. Ultimately, achieving that would align well with one of the SEC's objectives for the Rule, as mentioned earlier.

Implementing aspects of Rule 2a-5 naturally took effort and was a challenge, whether related to the valuation of less liquid investments or to other matters. However, as with all challenges, when an entity answers the bell and works diligently, overall enhancement is often a result. The valuation operating model will likely continue to evolve and develop as Rule 2a-5 becomes more ingrained in the fabric of the process and as fund groups continue to respond to market developments that occur and risks appearing on the horizon.

Endnotes

1. Securities and Exchange Commission (SEC), Final Rule 2a-5 – *Good Faith Determinations of Fair Value*, December 3, 2020.
2. Ibid.
3. SEC, Administrative Proceeding File No. 3-21546, August 7, 2023, and associated press release.

About the FV survey and its authors

We conducted the FV survey in summer 2023, and participants representing 104 registered investment company fund groups completed it. FV survey participants included small, midsize, and large fund groups. Thirty-one percent of them have more than 100 funds within the fund group, and 29% have less than 15 funds. Approximately 15% of them managed mainly equities, 6% manage mainly fixed-income securities, and the remainder manage 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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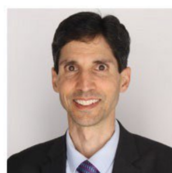

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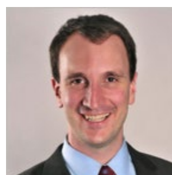

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