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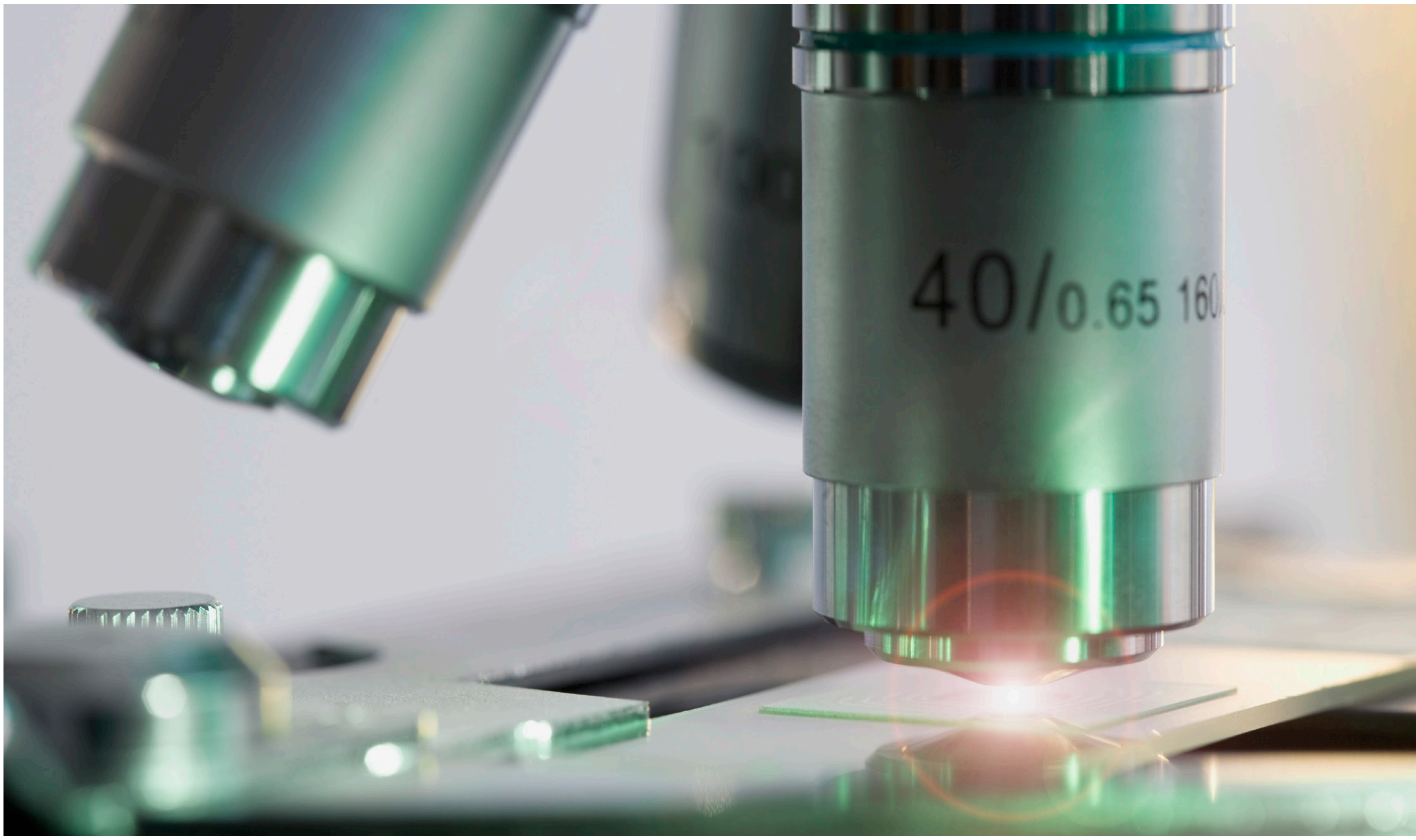
Fair Value Pricing Survey, Eleventh Edition
Finding the formula that fits



Investment Management
2013

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Executive summary

It goes without saying that there is no precise formula for determining fair value and performing related oversight. Those charged with valuation responsibilities have to do what any scientist in a lab would do: pursue a course of action, measure the results, and then refine the approach, taking into account changes in internal and external factors. Over the eleven years that we have conducted our annual Fair Value Pricing Survey, we have seen mutual fund firms continue to tweak their valuation efforts in search of the right formula. Along the way, we have catalogued both emerging practices and those that have matured into common industry processes.

Morgan Keegan settlement returns the spotlight to valuation oversight

The omnipresent threat of regulatory action has long hovered over the valuation process — a threat that became real this past year, when one board's oversight formula was publicly challenged. In June, the former mutual fund directors of the Morgan Keegan Funds settled administrative charges brought by the U.S. Securities and Exchange Commission (SEC) regarding their oversight of pricing procedures. This case, which came after a series of other SEC enforcement actions, was more than a warning shot — it was the strongest signal yet that the SEC has fund directors firmly in its sights, holding them responsible for fair valuation decisions.

Against the backdrop of the Morgan Keegan case, this year's survey garnered the highest participation since we launched it in 2001: a record 96 mutual fund firms representing more than $10 trillion in assets under management completed the survey.

SEC enforcement actions have mutual funds stepping up their focus on fair value.

A strong indication of how seriously fund boards are treating valuation issues after the case was evident from the fact that survey participants identified SEC enforcement actions as the most talked about valuation topic among board members outside of regularly scheduled meetings. These discussions, as well as deliberations during regular board meetings gave directors opportunities to assess whether they needed to change elements, such as the timing and frequency of their oversight, the type and extent of materials being reviewed, and the level of delegation provided to others. These efforts bore fruit as this year's survey shows that changes have been made to valuation oversight practices.

Seventy–eight percent of survey participants indicated they changed their valuation policies and procedures over the last year

Fifty-seven percent of survey participants have changed the level of detail in the valuation materials provided to the board

Fifty-four percent of survey participants said they have changed the types of valuation materials provided to the board

Figure 1

Types of valuation materials provided to the board	
Back-testing results on foreign equities priced using a standardized fair value process	86%
Written valuation memo regarding fair value decisions	84%
Information on the valuation controls	81%
Analysis of impact on NAV of individual fair value decisions	64%
Information on the valuation disclosures and procedures for financial reporting purposes	64%
Fair value price compared to actual sale price upon disposition	57%
Calculations supporting fair value decisions	53%
Prices for illiquid/thinly traded securities	53%
Value of each fair-valued position as a percentage of total investments	52%

Finding the right balance of information can require experimentation. Providing too much detail may create difficulties for board members in identifying salient points or relationships that may be obscured by the volume of data. Providing too little detail, on the other hand, may result in board members not being able to identify the key questions they should be asking. Whether fund boards decide to make changes to their oversight approach is, in the end, a matter of judgment. That judgment will likely be directly affected by the types of funds and the nature of investments they oversee, perceived valuation risks, and external factors that impact fair value decisions.

Apart from SEC enforcement actions, 34 percent of survey respondents identified trading halts as the second most popular subject prompting discussion among directors outside of regular meetings. Trading disruptions can affect the availability of security prices, and, as a consequence, can trigger the need for fair value determinations, particularly when trading halts extend past the time for fund net asset value (NAV) calculations. As technology glitches continue to plague securities exchanges, it appears likely that these issues will continue to demand attention from fund directors and management alike.

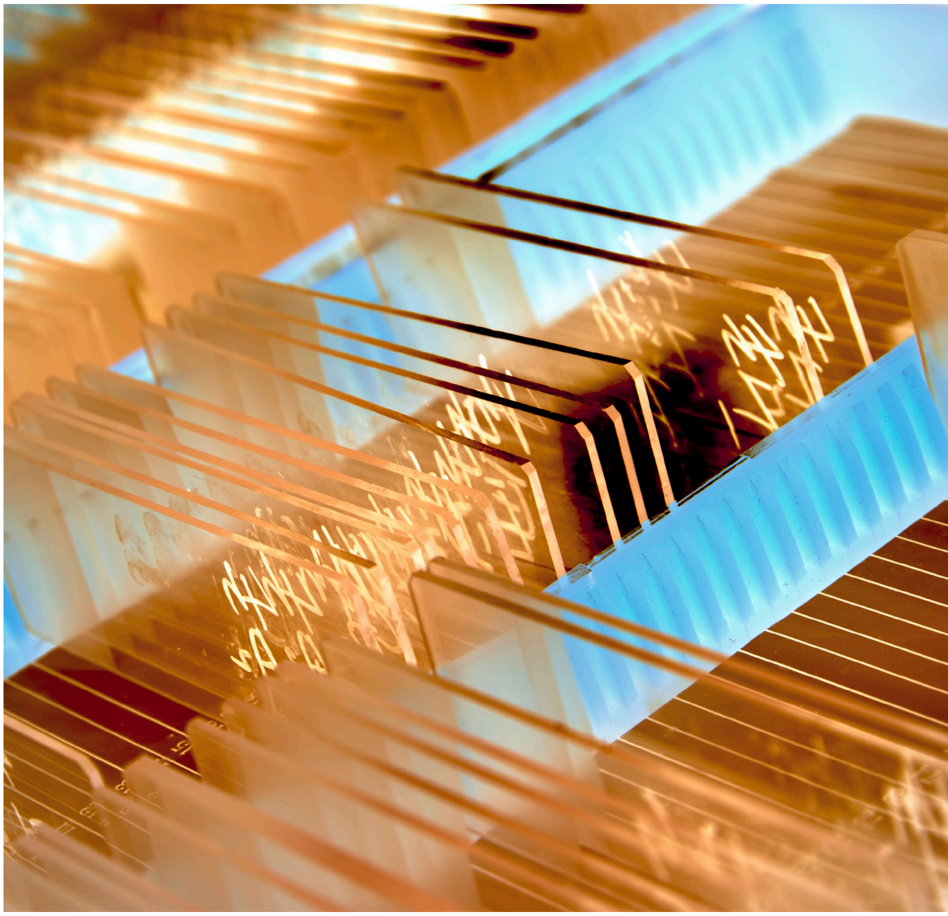
Balancing risk with efficiency

The survey findings show that risk management remains an integral part of the valuation alchemy for many fund groups. More than half — 51 percent — of survey participants indicated that they had identified valuation risks for one or more specific investment types as part of their annual compliance reviews under rule 38a-1 or formal risk assessment process.

Almost six out of seven respondents (84 percent) reported that their fund's chief compliance officer (CCO) has a full-time presence at board meetings when valuation matters were discussed. CCOs were also more actively involved in identifying risks associated with the valuation of investment classes. Additionally, 58 percent of respondents noted that adviser compliance personnel also have full-time participation at such meetings.

There is also an indication that some fund groups adjust the timing, nature, and extent of their processes and internal controls based on the type of investment or macroeconomic data. For example, certain funds identify investment valuations requiring further scrutiny by customizing their procedures based on the presence of market-related events, such as movements in an underlying benchmark or changes in credit quality. This approach can be an efficient way to increase effectiveness because it allows fund groups to focus on instances that may be more susceptible to valuation risk, rather than relying on standardized triggers that apply broadly across the asset class.

Given the current business and regulatory environment, a thoughtful assessment of valuation risks allows fund groups to balance both effectiveness and efficiency. In this regard, 38 percent of survey participants indicated that they had conducted an analysis in the last year designed to identify ways to improve the efficiency of the valuation process and to reduce redundancies. More than 60 percent of these same survey participants increased automation in their valuation processes in the current year, suggesting there may indeed be a way to rethink the formula for processes and controls to generate better results overall.



Looking ahead

We asked our survey participants to identify what they believe will be the most pressing valuation challenges over the next one to two years. Not surprisingly, navigating future actions, guidance, and expectations of the SEC was at the top of the list for many survey participants. There was a wide range of responses, but the most common are grouped below into these five main areas:

1

Changes necessitated by SEC regulatory action

Challenges in the regulatory arena include the uncertainties associated with the SEC's next action, including what it will say (e.g., how prescriptive its guidance or admonitions may be) and how it will say it (e.g., in an SEC speech, another enforcement action, or more formally through proposed industry-wide guidance). Given the complexities associated with valuations and the different practices followed within the industry, it will be important for the industry to continue to share its experiences and perspective in advance of any final SEC action.

2

Pricing vendor oversight

Pricing vendors continue to offer new asset class valuation products, as well as new tools to assist the industry in fulfilling its valuation responsibilities. This year, survey responses revealed an increased focus on transparency tools and how best to use them. These transparency tools can provide meaningful assistance to fund groups in determining whether to make price challenges, as well as aid in the overall understanding and assessment of a pricing vendor. With these potential benefits also come challenges, such as evaluating how frequently and formally to employ such tools and what steps funds may take in the valuation process when presented with contradictory evidence to the primary valuation.

3

Managing the external audit process

It can be difficult for fund groups to understand current external audit requirements and expectations for valuation testing. Gaining a full understanding of the external auditor's procedures is important, as well as being flexible enough to handle new audit requests arising because of changing requirements and expectations. Fund boards also need to ensure that they understand the benefits and limitations of the external audit in connection with their valuation responsibilities.

4

Derivative valuations

New asset classes have always created a degree of valuation risk. Derivatives are certainly no exception. Exchange-traded derivatives have historically been more straightforward from a valuation process, but the move to centrally cleared swaps has created a new dynamic for fund groups. Understanding the level of trading volume will likely be a factor in determining whether exchange-traded prices are reflective of fair value.

Over-the-counter derivatives can be a concern for fund groups when the instruments involve underlying securities that themselves are difficult to price. Accordingly, it remains very important for fund groups to truly understand the terms of the contracts and the inputs that are likely to affect the valuation. Fund groups holding more complicated derivatives may want to assess the benefit of having the necessary modelling skills in-house to value these instruments should markets and the environment change.

5

Board reporting and oversight

Even though we have seen industry practices coalesce in certain areas over the years, the governance and oversight structure that will function best very much depends on the particular circumstances of the fund group, and even to some extent, individual board members. Arriving at the appropriate mix of information, degree of director involvement, and overall delegation model can largely be driven by the size of the fund group and board, type and complexity of investments, and external factors impacting valuation risks. Changes resulting in greater oversight may be called for from time to time and yield beneficial results. This said, boards and fund management should also not shy away from discontinuing practices that are no longer effective. As with other areas, sustainability is a critical ingredient for success in the governance and oversight arena, even when the regulator’s spotlight turns up the heat.

Finding the right formula to address these and other challenges will require further exploration in the years ahead. The key will be anticipating and planning for future challenges, including building an infrastructure that is adaptable and flexible enough to address developments as they unfold.

Key findings

Other survey highlights

We have summarized below certain noteworthy survey results for three subject areas: policies and procedures, pricing sources, and specific investment type fair value considerations.

Policies and procedures

- Approximately 61 percent of survey participants indicated that the front office is responsible for notifying fund accounting or management if it becomes aware of any market or issuer-specific events that have occurred that may affect pricing.

Pricing sources

- Consistent with last year's survey, the majority of survey participants (82 percent, compared to 79 percent in the last year) indicated that they use different pricing vendors depending on the asset class.
- Fifty-five percent of survey participants pursue price challenges on both primary pricing sources and secondary pricing sources, with the remaining 45 percent only doing so for primary sources.
- Fifty-three percent of survey participants have a formal process in place specifying what to do when a pricing vendor reaffirms a price after the submission of a challenge.

Fair value considerations for specific investment types

Equities

- Eighty percent of survey participants compare each day equity prices received from the primary pricing source to a secondary source, compared to 77 percent last year, and 61 percent two years ago.
- The S&P 500 Index (either directly or through the use or S&P 500 futures contracts) remains the most common proxy used to identify situations in which the closing price for equities trading on foreign exchanges may require adjustment.
- Between 35 percent and 45 percent of survey participants use a zero trigger for evaluating the impact of market fluctuations on the value of foreign equities. The percentages vary based on the geographic region of the holding.
- Seventy-five percent of those survey participants sponsoring exchange-traded funds indicate that they use triggers to evaluate the impact of market fluctuations on the value of foreign equities and to determine whether they should adjust closing prices by a factor provided by a pricing vendor.

Fixed income

- Greater than 60 percent of survey participants use bid pricing exclusively, compared to 51 percent last year.
- Depending on the asset class, between 30 and 36 percent of survey participants indicated that they compare daily fixed income prices received from their primary pricing source to a secondary source, whereas less than 30 percent of survey participants reported doing so last year.
- Seventy percent of daily pricing validation checks (e.g., day-over-day comparisons and back testing) are performed prior to the 4:00 p.m. NAV strike.

Derivative contracts

- Eighty and 82 percent of survey participants determine valuations for interest rate swaps and credit default swaps, respectively, based primarily on prices obtained from a pricing vendor.

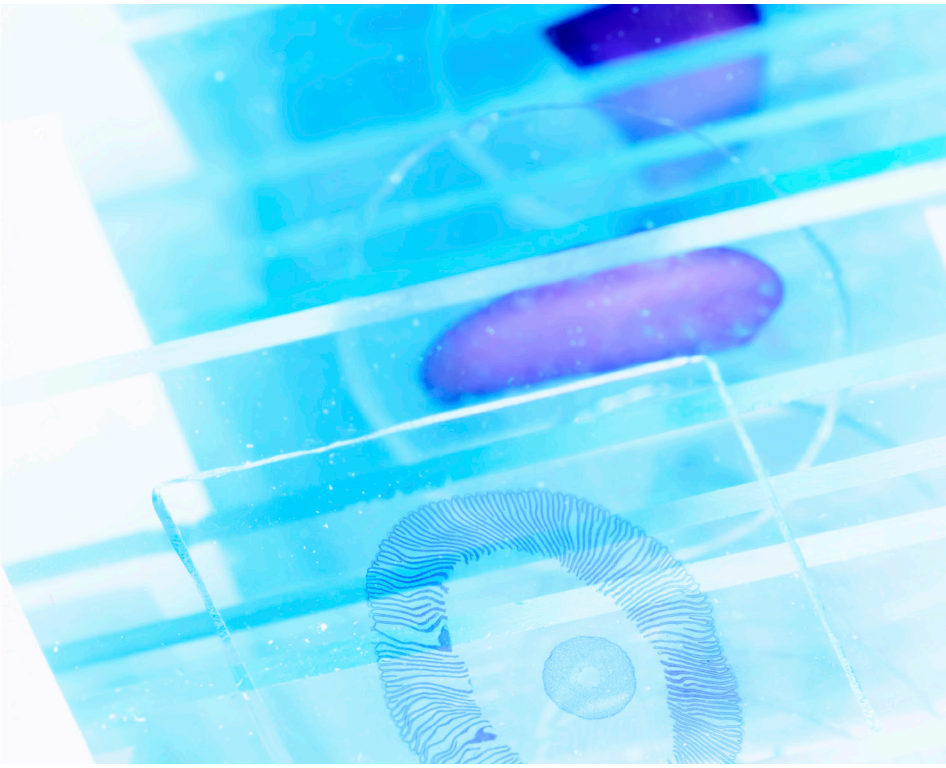
Restricted securities

- Fifty-five percent of survey participants use a discount of five percent or less from the price of the registered issue of the same or similar security when the restriction on a security is three months or less.

Conclusion

This year's survey illuminates once more that valuation practices and processes are continually being refined in ways large and small. After all, valuation is an ongoing and iterative process — even when a fund finds the formula that fits, its investment setting and other factors can and often do change. Over the years, we have seen our survey respondents adjust to these changes, and we suspect that they will continue, particularly as the SEC steps up its focus.

Background
Deloitte's eleventh annual Fair Value Pricing Survey aggregates the views of 96 mutual fund firms and respondents hold more than $10 trillion in assets under management. The population of survey participants represents a diverse mix of mutual fund firms encompassing various sizes, asset classes, and geographies. The survey took place between June and August 2013.



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