Mutual funds’ focus on valuation responsibilities and requirements has been heightened by the SEC Division of Investment Management’s recent emphasis on “valuation guidance” as one of its top three areas of focus for 2013. Several high-profile valuation-related enforcement actions have also contributed to this renewed valuation focus, including the Securities and Exchange Commission’s recently settled case against the directors of several Morgan Keegan funds.

Mutual fund boards and valuation professionals have been responding to prompts from regulators by reviewing the processes and procedures underlying portfolio valuations. The following are some of the key valuation challenges and how these professionals can approach them:

**Balancing Board Involvement and Level of Reporting Detail**

The SEC’s Accounting Series Release (ASR) No. 118 details the responsibility of fund directors to review the “method” used in valuing each issue of security in the company’s portfolio when market quotations are not readily available.

Compliance professionals are recognizing that the valuation methods employed by the mutual fund continue to evolve in light of the proliferation of new asset classes and investment products, including notable growth in alternative investment funds.

Other factors include changing regulations, the changing structure of equity and fixed-income markets, and substantial technology advances. Consequently, fund executives must understand the underlying valuation techniques that their firm implements, review all quality-control processes that the fund firm uses and ensure that all valuation activities are free of material conflicts of interest.

Not surprisingly in this environment, investment companies and their boards are working continuously to improve their valuation practices and processes.
A recent industry exit poll at a client event we held in June revealed that 82% of attendees said their board-reporting requirements increased during the past year.

**Determining Market Valuations for International Securities**

Firms typically calculate their funds’ net asset value at the close of the New York Stock Exchange. However, valuations for securities that principally trade in foreign markets may be as much as 12 or even 15 hours old when the NYSE closes. Fund firms should therefore have procedures in place to ensure that valuations for foreign securities reflect current market transactions.

Many fund firms have adopted systematic procedures to fair-value international equity holdings as of the close of the NYSE. These fair-value techniques are no longer limited to international equities.

As market-moving events ripple through international markets, U.S. fund firms may need to consider incorporating fair-value techniques to value their international bonds in addition to their non-U.S. stocks. This is particularly important at times when international fixed-income markets are closed.

**Understanding Third-Party Valuations**

We have seen a spike in the number of due-diligence meeting requests from our fund clients, plus an increase in attendance by independent directors, all in an effort to gain additional information about third-party-evaluated pricing processes. In 2012, our firm held more than 400 diligence meetings related to our evaluations process, including more than 100 meetings with directors or valuation committees, an increase of 26% versus the prior year.

These meetings and client visits may include a look at a third-party provider’s evaluation methodologies, compliance policies, the availability of Statements on Standards for Attestation Engagement (SSAE) 16 reports and business-continuity practices, among other information.

The focus of these meetings has changed from discussing the service provider’s procedures to discussing how these guidelines perform during a specific situation such as Hurricane Sandy.

**Regulatory Guidance Related to Accounting Standards**

Comments from the SEC and the Public Company Accounting Oversight Board indicate an increased focus on the determination of fair-value measurements used in financial reporting, particularly when firms use valuations from third-party sources. We see an increasing demand from our mutual fund clients to provide support for their Financial Accounting Standards Board Accounting Standards Codification Topic 820 and International Financial Reporting Standards fair-value measurement determinations and disclosures.

**Documenting Valuation Procedures and Managing Conflicts of Interest**

Mutual fund firms should be implementing best practices to manage valuation risk. This should include documenting and cataloguing the key inputs and methodologies that they use to support their valuations. We provide clients with our methodology documentation, SSAE 16 reports and other materials that can assist them with these activities.

The increased focus on valuation practices is not slowing down, with 94% of exit poll respondents attending our June client event indicating that their pricing validation practices increased during the past year.

This means that operations and compliance executives must continue to make efforts to prioritize oversight of their firms’ valuation processes and procedures.

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