Asset Management
Valuation survey

December, 2010

pwc

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Dear clients and friends,

PwC's asset management practice is pleased to publish the results of a Web-based survey designed to gather, analyze, and share information about emerging trends in the valuation governance process.

The need for such information is urgent. In recent years, asset management firms have faced increasing challenges in valuing their investments due to rapid changes in liquidity and volatility in the securities, derivatives, and real estate markets. At the same time, in the wake of several high-profile enforcement actions, the Securities and Exchange Commission (SEC) has placed a priority on identifying industry trends and activities that pose a higher risk to investors and the marketplace. One significant high-risk activity identified by regulators is the valuation and related governance processes.

The SEC is not alone in focusing on the state of the valuation process. Investors also are demanding greater risk management and transparency, as well as independence in, and oversight of, the valuation of securities. The increased demand for transparency is particularly challenging for asset management firms, given the wide variety and massive scale of market data available. To address these challenges, asset managers need to identify, understand, and prioritize the most valuable information from the best sources.

To help asset managers respond effectively to regulatory and investor demands, PwC conducted this survey to explore trends in the valuation governance process. The survey was designed to gather data from industry participants to help executives and other stakeholders to benchmark their valuation governance practices against their peer groups and across the asset management industry as a whole. The survey targets four industry sectors:

- Traditional/Registered
- Alternative
- Private equity and venture capital
- Real estate

For the survey, we polled more than 50 US-based asset managers of varying sizes. Two of the firms that participated manage less than $500 million in assets, while 12 manage more than $100 billion.

Two-thirds of the asset managers we surveyed across all sectors are registered investment advisers (although the percentage varies significantly among the sectors). Of all the registered firms we surveyed, 28% have been subject to an SEC sweep examination on valuation in the past. While only 1% of these exams occurred in the last 12 months, considering the environment in Washington, D.C., and the focus on requiring many alternative, private equity and real estate firms to become newly registered, we expect to see an increase in such exams.

Many unregistered firms could face similar scrutiny of their valuation processes in the near future. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was signed into law on July 21, 2010, unregistered managers may be required to register with the SEC and will be obligated to comply with all of the applicable provisions of the Investment Advisers Act of 1940 (Advisers Act) and the rules that have been adopted by the SEC. All hedge fund and private equity advisers that are required to register with the SEC must do so before July 21, 2011, and must be fully compliant with the requirements under the Advisers Act.

Whether you are a new or established registrant, we hope you will find our survey results and analysis helpful in providing guidance about current valuation governance practices. If you have any questions about the survey or its results, please feel free to contact me or Joe Wiggins, PwC partner leading our asset management benchmarking committee, at (312)-298-3004 or joe.wiggins@us.pwc.com. We will use your feedback to refine future surveys, to help ensure that we are providing the guidance you need to navigate in a volatile, difficult environment.

Regards,

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Executive summary

Introduction

Pricing and fair valuation of portfolio securities continue to be challenging for the management and boards of asset management firms, and for market data providers. To help asset managers address these challenges, PwC conducted a Web-based survey of more than 50 firms in four core sectors of the asset management industry: traditional/registered investment firms (traditional), alternative investment firms, private equity/venture capital firms, and real estate asset managers.

Our survey covered a broad range of issues facing asset managers across sectors, from the key valuation risks facing their organizations to who is responsible for the valuation process and oversight of the process. We sought to gain a high-level perspective on the concerns facing asset managers with respect to valuation and to solicit details about their governance processes that might help their peers within and across sectors to improve their own processes.

While not all survey responses apply to every sector, many asset managers can benefit from the experience of their peers in other sectors. In particular, unregistered firms that may be required to register with the SEC in the near future can learn from their registered counterparts about how they may need to operate in a more regulated environment with increased scrutiny by regulators and investors.

Key valuation risks

A sound valuation process begins with a robust definition of the key valuation risks that senior management and the board (or its equivalent) agree they must monitor and mitigate. Once the risks are identified, management can develop controls that monitor and mitigate the risks, and provide reports to those charged with governance.

In our survey, we proposed nine valuation risks that we believe are key risks for most organizations. If not appropriately monitored and controlled, these risks can significantly increase the potential for error in valuing portfolios:

- Market volatility and changing liquidity
- Extensive use of matrix pricing
- Valuations obtained from a single source or counterparty
- Reliability of data provided by pricing services
- Reliability of information provided by credit rating agencies
- Use of internal information provided by portfolio managers or deal teams to estimate fair values
- Use of internally developed models to value securities
- Process around management overrides
- Timely identification of significant events in performing reliable valuations

There is no foolproof method to eliminate these valuation risks, but the risks can be minimized through the vigilance and oversight of senior management and boards.

The role of the board (or equivalent) in the valuation process

With respect to oversight of the valuation process, the SEC has indicated that the board of directors is responsible for a fund's valuation policy. Furthermore, the SEC expects directors or their equivalent to exercise independent, objective oversight and judgment with respect to execution of the policy and related valuation and pricing procedures.

Because the directors of traditional funds have clear responsibility for valuation, this responsibility normally resides with the board or a valuation committee of the board. This board committee establishes the valuation policies and procedures to be executed by fund management or others and normally reviews the adequacy of the valuation procedures and the accuracy of valuation results.

An interesting perspective noted by the traditional fund managers relates to the oversight of pricing sources and vendors. While more than two-thirds of traditional fund respondents (68%) cited a lack of reliable data from pricing services as a key valuation risk, their boards have adopted two distinct approaches to managing this risk through oversight of pricing vendors. Roughly half of the boards (48%) have direct or indirect oversight of vendors, while an almost equal percentage (47%) have delegated this responsibility to management. Overall, boards of traditional funds tend to be heavily involved in governance of the valuation process, regardless of whether they delegate vendor oversight to management.

In carrying out their responsibilities, generally boards have looked to the valuation committee and the compliance function to help execute their duties. The Investment Company Act of 1940 requires that securities for which market quotations are readily available shall be valued at current market value, and other securities shall be valued at fair value as determined in good faith by the board of directors. The SEC has stated that while boards can delegate day-to-day valuation responsibility to others, they still retain ultimate accountability for setting policies related to the valuation of portfolio securities.

Among alternative funds with no outside board, 60% have no enterprise or operational committee to oversee the valuation of investments. Within the private equity and venture capital sector, 30% of respondents identified no oversight process beyond the valuation committee. The remaining 70% were split between boards, risk committees, limited partner (LP) advisory committees, or direct oversight from the partners of the general partnership. Within the real estate sector, half of respondents indicate that their firms have no enterprise or operational committee to oversee the valuation of investments. Given the changing regulatory landscape and investor demands, these governance structures may need to evolve.

The role of the valuation committee

What is interesting is that based on our survey results, it appears that the use of the valuation committee or its equivalent is becoming the norm, regardless of the sector and irrespective of whether a firm is registered. As many would expect, within the traditional funds sector, asset managers are generally similar in their approach to the governance process. All have valuation committees, and the information provided to the committee and the board is largely consistent across funds. The top four documents provided to the valuation committees of traditional funds are the fair value listing, stale price reports, pricing error reports, and look-back testing. The four documents most commonly given to the board are vendor

Reports and analyses provided to the board (or equivalent)

The board requires adequate information in order to exercise their oversight responsibilities effectively. One interesting observation from the survey participants is that in the alternative funds section 38% do not provide valuation information to the board of their offshore corporations. This suggests that presently offshore boards may not have the same level of transparency to the valuation documentation and conclusions when compared to other asset management sectors. This may be an area for change in the coming year as registration of firms commences.

Our view is the following information might be considered effective, as a starting point, for inclusion in board reports:

- Results of independent price verification, outliers, and exceptions compared to variance thresholds
- Early identification of pricing issues
- External fair value disclosures that adequately describe risk and other salient factors
- Clear documentation summarizing the investment valuation approach applied and key assumptions

Alternative fund managers in particular will need to evaluate their governance process beyond management and valuation committee levels. Based on the survey results, the board or its equivalent has a limited role in the valuation process compared with traditional fund managers. With passage of the Dodd-Frank Act, alternative managers with more than $150 million in assets under management are now required to register with the SEC and be subject to the Advisers Act. To comply with the Act, they will be required to have policies and procedures in place that will, at a minimum, address some of the key risks inherent to all asset managers, one of which is the valuation of client holdings.

due diligence reviews, illiquid reports, pricing errors/tolerance reports, and 2a-7 compliance reports.

To expand into other sectors, among the firms participating in our survey, 94% of alternative asset managers also have valuation committees, as do 88% of real estate firms and 60% of private equity asset managers (an additional 10% of private equity firms are considering creating such a committee). The emergence of valuation committees across sectors aligns with the expectations of regulators, who are increasingly looking to those charged with governance to appropriately carry out their oversight responsibility for a fund's valuation process.

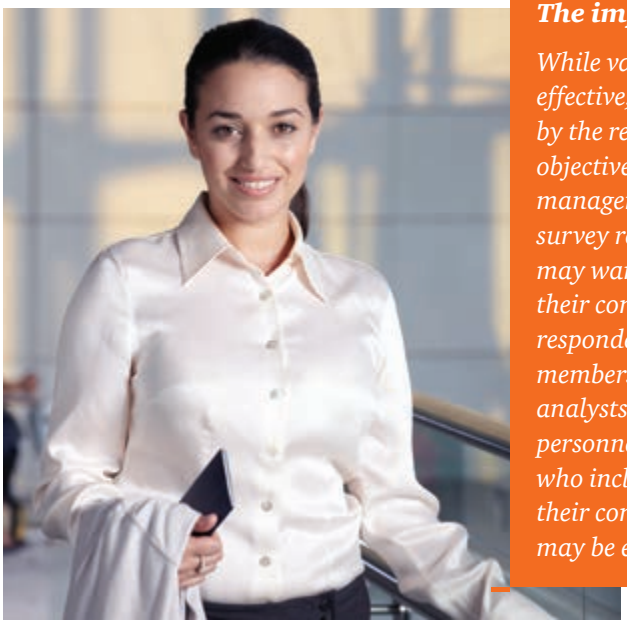
The valuation committee normally consists of senior management with responsibility to resolve valuation questions and exercise oversight of pricing vendors, administrators, and fund personnel involved in the valuation process. We view the trend of having a valuation committee in place as an important aspect of the control environment—and one that will be emphasized by regulators.

Independence, accountability, and segregation of duties of committee members are important concepts that effective valuation committees and firms embrace. To reduce the potential for management bias, an effective structure to consider is having the voting members of the valuation committee be independent of the portfolio management function. For instance, while investment managers and traders provide important input to the committee, they would not serve in a decision-making role under this governance model.

In addition, in our experience the chief compliance officer (CCO) or chief risk officer (CRO) typically does not serve in a decision-making capacity, more often attending valuation committee meetings only to observe and ensure that the process is performed in accordance with approved valuation policies and procedures. Generally, it is appropriate to separate CCOs from valuation-related operational roles so that they do not face conflicts of interest in reporting on compliance processes in which they actively participated.

Alternative, private equity firms and real estate firms that will be required to register with the SEC will need to designate a chief compliance officer. In traditional fund operations, the CCO has historically had a dominant role in developing monitoring controls and mitigating valuation risks. The CCOs for many new advisers will need to carefully consider their roles in the overall valuation process.

It is important for valuation committee members to bring objectivity and good judgment to the deliberations and recognize that their charge is to be fair to all stakeholders. Among other things, this means that the committee does not always seek the highest valuations, or conversely, does not strive to be overly conservative.



The importance of independence

While valuation committees can be effective, their members are expected by the regulators and investors to be objective and independent of the portfolio management function. Based on the survey results, some firms in all sectors may want to address the composition of their committees. Across sectors, some respondents reported that their committee members include portfolio managers/ analysts and/or other investment personnel, and the number of respondents who include independent members on their committees was lower than what may be expected in the future.

Reports and analyses provided to the valuation committee

In well-governed asset management firms, the following controls, processes and reports are in place and can serve as the basis for reporting to the valuation committee. (Note: not every control and process applies to all sectors)

Controls	*Additional processes and reports*
• Review pricing sources and vendors • Assess the validity of data received from portfolio companies • Assess the relevance of models and methodologies used across the organization • Assess the validity of data received from underlying vendors and experts • Monitor the reasonableness of each security's price changes from the previous day • Periodically compare primary to secondary sources • Select appropriate market comparables • Identify "significant events" that affect market prices	• Independent review of securities requiring manual input • Stale price review mechanism • Report comparing portfolio sales or subsequent market events such as IPOs to previous valuations • A form of "look-back" testing, particularly for foreign securities to which a fair value factor has been applied

The role of management

In all asset management firms, management is responsible for the day-to-day operations of the funds it oversees, including the selection and oversight of key service providers, regardless of the funds' legal structure or regulatory oversight. Compared to traditional funds, the management of alternative and private equity funds plays a more significant role in the valuation process. In these firms, management tends to provide significantly more input into valuations, and in many cases there is little external oversight. These sectors may need to address the lack of independence and external oversight as they begin their infrastructure reviews leading up to registration with the SEC as US investment advisers.

Management also is responsible for managing the pricing and valuation process for fund securities. This process involves identifying the valuation risks implicit in each fund's investment strategy and creating a series of controls to seek to mitigate and manage those risks. This process has become much more difficult with the increasing complexity in investment strategies and uncertain volatility in the market. The challenges are amplified as a result of valuation inputs in the marketplace that are observable in certain asset classes and the limited transparency of the quotes being provided by pricing vendors, counterparties, and broker-dealers.

Oversight of the Disclosures Process

Regardless of whom in the organization is designated to review disclosures made to the investors and regulators it is important that a number of key constituents in the organization play an active role in the review process. Based on responses there is a diversity in practice among the roles played by the CCO, the board and senior management in the disclosure review process. Regardless of how these responsibilities are distributed or aligned both the CCO and the board have important roles to play in monitoring compliance with the firms policies and procedures and ensuring that the stakeholders i.e investors and regulators are provided with adequate disclosures. Ultimately the board or its equivalent will have the final responsibility to maintain oversight and in order to discharge this fiduciary responsibility they will have to assess whether they have received sufficient information to properly do so.

Our point of view

An organization with an effective valuation governance process in place operates according to certain well defined principles and practices. Examples of such practices are highlighted below.

Responsibility for the valuation process. A senior management group is responsible for management and oversight of control and valuation policies and procedures. The group reports the results of its work directly to the board of directors or its equivalent. The group includes representation from market and credit risk management, financial and product control groups, senior business management, tax, legal, and compliance. Senior management prepares and reviews documentation and, where relevant, the board of directors or its equivalent reviews all processes involved in determining and verifying fair values.

Design and approval of valuation methodologies. The board of directors, valuation committee, or its equivalent approves a high-level framework for valuation methodologies. The design of detailed valuation methodologies is the responsibility of senior management. All significant changes to methodologies are reported to the board or its equivalent.

Consistency of valuation. Asset managers promote consistent pricing policies across their organizations and foster a sense of awareness and urgency, particularly among those who are responsible for valuing portfolios and calculating net asset values. This protects the organization against charges that it favors one group of stakeholders over others, and it addresses the greater uniformity in valuation procedures arising from the application of the US GAAP accounting standards contained in ASC 820 (formerly FAS 157).

Independent price verification. A qualified and experienced independent price verification (IPV) group is responsible for determining the fair value of securities. Group members typically have significant on-the-job experience as well as specialist training. Where fair value is a critical component of reported results, the IPV groups are most effective when they have access to dedicated quantitative professionals within financial controls or risk management to deal with complex price verification issues.

Periodic review of pricing service providers. Management performs periodic formal reviews of pricing service providers, using consistent criteria and metrics to rate vendors, and retains documentation of these reviews to support conclusions made and actions taken. Management also corresponds with others in the industry to assist in evaluating the quality of the vendors' past valuations.

Identifying and mitigating valuation risk. The CCO or CRO, financial managers, and accounting managers play important roles in developing monitoring controls and mitigating valuation risks. It is a good idea to conduct periodic sessions to identify potential valuation risks, determine how to control recurring risks, and develop plans to address risks that could occur unexpectedly, such as a significant event.

Timeliness of reporting. The CRO or CCO determines how often reportable matters are communicated to senior management and boards. To facilitate proper oversight of the valuation process, valuation policies and procedures are provided to the board or valuation committee annually, at a minimum. Reporting processes are reviewed for continual improvement opportunities as the firm seeks to stay abreast of difficult valuation situations and maintain the effectiveness of controls as circumstances change. For instance, when markets become more volatile, and fair valuations increasingly replace prices based on market transactions, the committee becomes more active and may meet more often to determine how to provide the required oversight.

Highlights of survey results by sector

Traditional

- 90% of respondents cite market volatility and changing liquidity as valuation risks, and 68% cite concerns about the reliability of data provided by pricing sources.
- Roughly half of traditional fund boards (48%) have direct or indirect oversight of their pricing vendors, and 47% have delegated complete oversight to management.
- Only 21% of respondents use members independent from the organization on valuation committees. Less than half have finance personnel, such as the CFO, serving on the committee.
- The survey responses continued to indicate a diversity of practice exists with respect to the materials provided to the valuation committee: of 11 possible reports, only 7 were provided to the valuation committee[1] more than 50% of the time.
- Almost half of respondents do not have an independent pricing verification (IPV) group in place.
- 53% review their valuation policies and procedures annually, while another 31% do so more frequently (21% quarterly, 5% semiannually, and 5% monthly). Whether annual reviews are sufficient will depend to a large extent on the complexity of the investments. 84% are updating the board or audit committee on a quarterly basis.

Alternative

- 81% identified market volatility and changing liquidity as the most prevalent valuation risk, followed by information obtained from the portfolio managers in estimating fair value (57%) and the risk associated with single sources, such as brokers or counterparties (50%)
- 75% noted that the board has delegated complete oversight of vendor pricing services to management.
- 74% said that the CFO, who in most alternative fund organizations is ultimately responsible for valuation, sits on the valuation committee.
- There is a lack of consistency in materials provided to the valuation committee: of 16 possible reports, only six were provided to the valuation committee more than 50% of the time.[2]
- 63% do not have an internal pricing group that is responsible for pricing illiquid or difficult-to-price securities. Among those that do, half of respondents indicated the pricing group reports to the CFO, and the other half stated it reports to the valuation committee.
- 94% have a valuation committee. This response is encouraging given many of the alternative firms surveyed are currently not registered.

Private equity/ venture capital

- 70% of respondents cite selecting and obtaining appropriate market comparables as a key valuation risk, and 60% named both timely identification of significant events and the use of models as key risks.
- 70% do not use external valuation experts to value their portfolios. This is not an uncommon or unexpected finding because many firms have the requisite resources internally to perform the valuations.
- 60% indicate the CFO or equivalent is a member of the valuation committee, reinforcing the conclusion that finance personnel in private equity organizations are often heavily involved in the valuation process.
- 60% have a valuation committee, and another 10% are considering implementing one.
- 50% have finance staff on their valuation committees, 40% have investment professionals, and only 20% indicate the CCO is on the committee.

Real estate

- 75% of respondents view market volatility and changing liquidity as key valuation risks, followed by use of internal information (63%).
- Asset management (88%) and acquisitions/ underwriting professionals (63%) are the disciplines most often represented on valuation committees.
- 88% use external valuation experts as an independent resource to establish valuations, and this is considered an industry norm.
- 88% have a valuation committee in place.
- 75% indicate that senior management or a fund administrator is responsible for reviewing and approving specific valuation policies and methodologies.

1. The seven reports are the illiquid reports, stale price reports, pricing error/tolerance reports, fair value listing, management overrides, pricing vendor review documentation, and look-back testing.

2. The six reports are the fair value listing, ASC 820 leveling, summary of the valuation methodology approach, portfolio company information, third-party valuations prepared by valuation experts, and models used in the valuation process.

Conclusion

The valuation process will continue to be challenging for asset management firms. The results of our survey, described in more detail in the following sections, highlight how asset managers across sectors are addressing the many challenges related to the valuation governance process. By implementing sound valuation processes, ensuring the right people are involved, and providing oversight groups with the information they need to carry out their responsibilities, asset managers in all sectors can better manage their risks and operate more effectively in an environment of increased scrutiny by regulators and investors. In doing so, they will achieve the key goal of ensuring that they manage their business and reputational risks and that valuations are fair to all stakeholders.

As alternative investment firms, private equity firms, and real estate asset managers review the survey results, we encourage them to carefully consider the responses provided by traditional. Once newly registered, they can expect the valuation of assets to be an area of regulatory focus. Therefore, the responses of traditional investment firms will be useful as these new registrants reevaluate their current governance structures in light of the passage of the Dodd-Frank Act.

Traditional investment firms

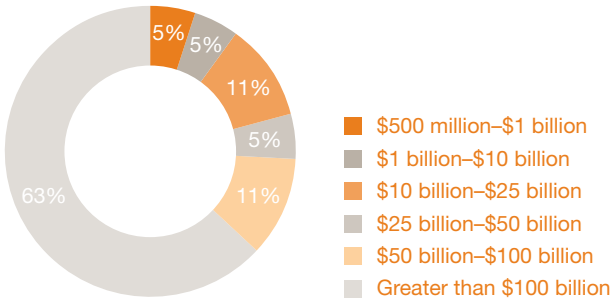
Survey results by sector

Introduction

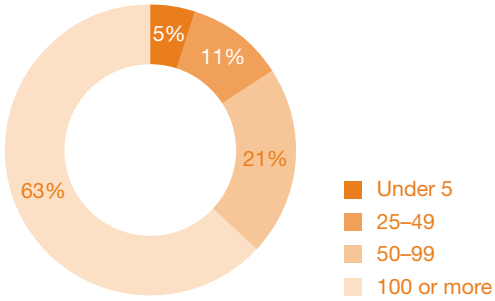
PwC surveyed traditional registered investment funds that manage from $500 million to more than $100 billion in assets. On the following pages we provide an overview of the survey findings, details of participants' responses to each of the 19 questions we posed, on topics ranging from the key valuation risks the organizations face to their review of disclosures, and our point of view on each topic.

Participant statistics

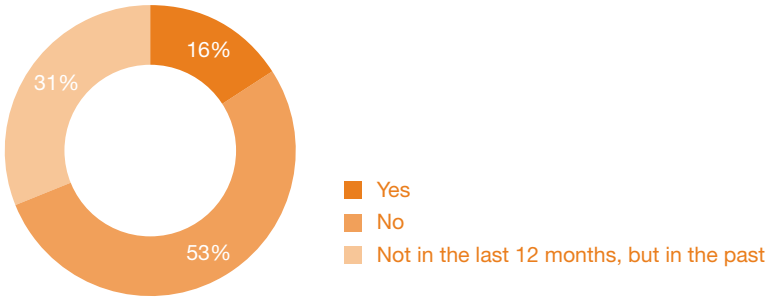
What were the assets under management as of December 31, 2009?



What was the number of funds under management as of December 31, 2009?



Has the fund complex been subject to a sweep examination by the SEC on valuation in the last 12 months?



Overview of roles and survey findings

The following is an overview of the role of management, the valuation committee, and the board of traditional funds, as well as their oversight of valuation disclosure activities. Responses to individual survey questions, and PwC's perspective on those responses, follow (see "Survey results").

The role of management

In all asset management firms, management is responsible for the day-to-day operations of the funds it oversees, including the selection and oversight of key service providers, regardless of the funds' legal structure or regulatory oversight. Management is also responsible for the valuation of real estate investments. This process involves identifying the valuation risks implicit in each fund's investment strategy and creating a series of controls to seek to mitigate and manage those risks. This has become much more difficult with increasing complexity in investment strategies and uncertain volatility in the market.

Most traditional fund respondents (90%) identified market volatility and changing liquidity as one of the key valuation risks they must manage. Sixty-eight percent are concerned about the reliability of data provided by pricing sources. After these two risks, there was a significant drop-off in consistency of responses; none of the remaining risks noted in the question was identified by the majority of respondents as a key risk they must manage.

An appropriately qualified and experienced valuation group has long been established as a key control in the valuation process, particularly when dealing with changing liquidity. The results of the survey showed that 89% of traditional fund respondents believe their organization has the appropriate level of resources, skills, and experience on their valuation teams to evaluate the data coming into their organizations.

The role of the valuation committee

All of the traditional fund respondents have a valuation committee. In most funds (74%), the committee oversees the valuation of all asset classes, not just illiquid or fair valued securities.

Traditional fund respondents indicated that valuation committees most commonly include members from compliance (84%), legal (80%), fund administration (68%), as well as internal valuation specialists (58%). Independence, accountability, and segregation of duties are important organizational concepts that are embraced by effective boards and managers. Given the importance of these concepts, it is worth noting that only 21% of respondents include on their valuation committees members who are independent of the organization. In addition, less than half of the respondent committees include finance personnel, such as a chief financial officer (CFO), who could help to ensure accountability.

The role of the board

The survey responses indicate that many boards are reviewing the same information that is provided to many of their subcommittees. Such consistency suggests that these boards are well informed, equipped with the information they need to carry out their fiduciary responsibilities.

Respondents differed significantly with regard to their oversight of pricing vendors. Most respondents considered the reliability of data provided by pricing services a risk, but their boards followed two distinct approaches to monitoring this risk. Approximately 48% of boards either had direct or indirect oversight of their vendors while an almost equal percentage (47%) had delegated complete oversight to management.

For the most part, however, boards seem relatively hands-on, as evidenced by their approach to valuation methodologies. Many boards (32%) or their designee and the valuation committee (58%) approved the specific methodologies. Additionally, 84% of boards or their valuation committees received detailed valuation analyses on a quarterly basis.

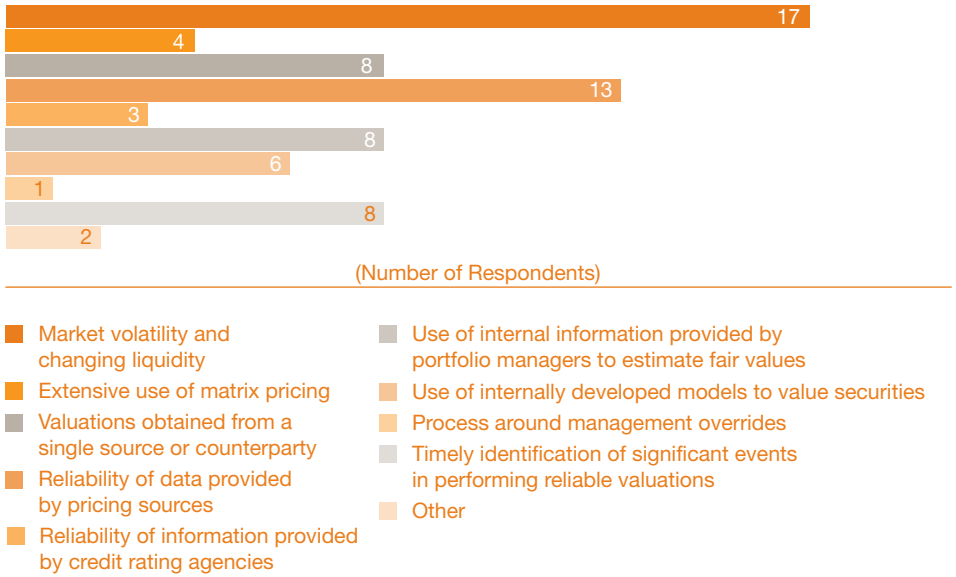
Oversight of the disclosure process

We queried respondents about their firms' valuation reporting practices as they relate to their key stakeholders—investors. In 47% of firms participating in our survey, financial statement disclosures are reviewed by the audit committee or their designee while another 47% of boards have turned over this reporting responsibility to management. Forty-seven percent of respondents indicated the chief compliance officer (CCO) is responsible for ensuring compliance with disclosures made to the board and to investors.

Survey results

Key valuation risks

Which of the following are **key** valuation risks specific to your organization? Select all that apply.



PwC point of view

A sound valuation process begins with a robust definition of the key valuation risks that senior management and the board agree they need to monitor and mitigate. With the risks identified, management develops controls that monitor and mitigate the risks, and provides reports to those charged with governance. We believe that the valuation risks highlighted in the chart above represent key risks for most organizations, and if not appropriately monitored and controlled, significantly increase the potential for error in valuing portfolios.

Observations

Topping the list of valuation risks, 90% of traditional asset managers indicated that the impact of market volatility and changing liquidity on pricing is a risk to their business. Second, at 68%, was concern over the reliability of data provided by pricing sources.

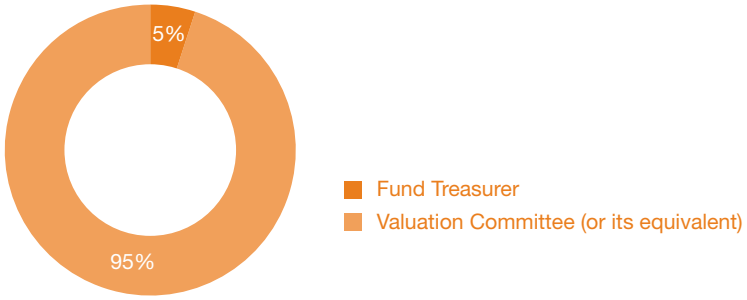
Beyond these two risks, the consistency of responses dropped off significantly. Of the eight remaining risks, the most consistently identified ones were a source of concern for only 42% of respondents. A small number of respondents noted the following "Other" risks: lack of transaction prices, no change in prices provided by vendors, and the valuation process becoming routine and personnel becoming complacent, resulting in a lack of skepticism on the part of valuation staff.

It is worth noting that many respondents did not select the process around management overrides as a key valuation risk. Asset managers would do well to assess periodically why overrides are occurring, as frequent overrides are often a red flag, indicating that the quality of pricing service valuations has declined or that a bias needs to be addressed. To ensure that risks are properly identified, it is also a good idea to conduct periodic assessments to identify potential valuation risks, determine how to control the recurring risks, and develop plans to address risks that could occur unexpectedly, such as a significant event.

As with other risk management operations, there is no foolproof method to eliminate valuation risks, but the risks can be minimized through the vigilance and oversight of senior management and boards. In an effective organization, these stakeholders never lose sight of the ultimate goal: valuations that treat all stakeholders fairly.

Responsibility for the valuation process

Who in management is ultimately responsible for the valuation process?



PwC point of view

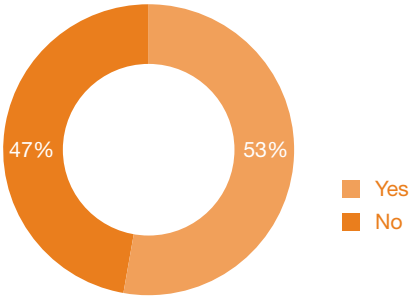
Consideration should be given to assigning a senior management group responsibility for managing and overseeing control and valuation policies and procedures. This group would report the results of its work directly to the board of directors or the audit committee. The group will be more effective if its responsibility and reporting obligations are clearly defined. Members may include representation from market risk management, credit risk management, financial control/product control groups, senior business management, tax, legal and compliance. This group would prepare and review documentation and, where relevant, the board of directors would be involved in approving the fair values.

Observations

Almost all (95%) of respondents identified the valuation committee as the group responsible for the valuation process. We believe this responsibility is appropriate, since it allows for some degree of independence and objectivity through representation from several key stakeholders in the organization, rather than a single person or a front office.

Independent price verification

Is there an independent group that is responsible for pricing illiquid or difficult to price securities?



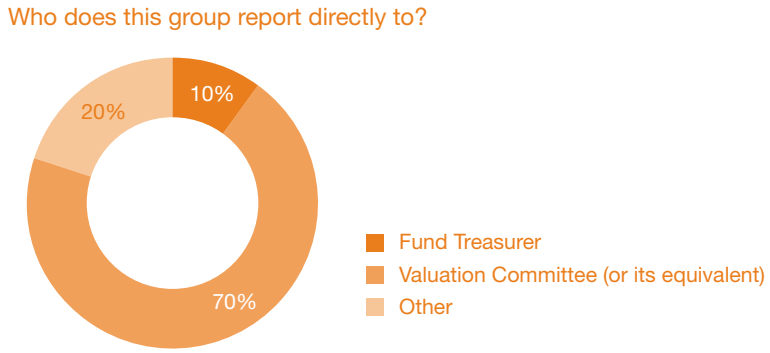
PwC point of view

Firms may want to consider having an appropriately qualified and experienced independent price verification (IPV) group be responsible for determining the fair value of real state investments. Where fair value is a critical component of reported results, the IPV group can have dedicated quantitative professionals within the financial control or risk management group to deal with complex valuation issues. A key component of the IPV group's work is to verify the valuation model, independent of risk-taking activities, to employ highly experienced and qualified quantitative professionals.

Observations

Almost half of the traditional asset managers responding to our survey did not yet have an IPV group in place. This might be appropriate, depending on the complexity of their investment strategies and volume of securities involved. That said, management should monitor the evolving complexity of the firm's investment strategies and determine whether it is necessary to have a dedicated IPV group.

Oversight of the valuation process



PwC point of view

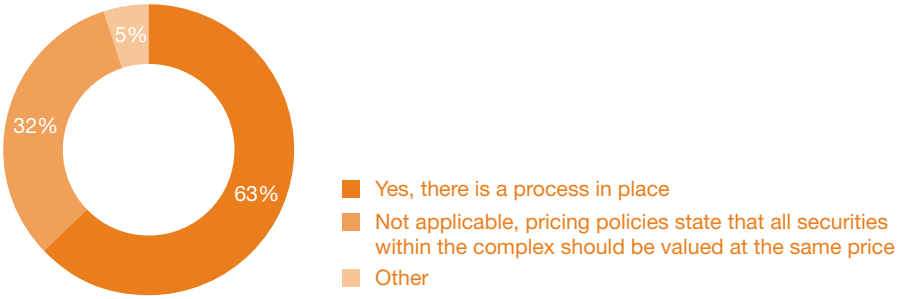
With respect to oversight of the valuation process, the SEC has indicated that the board of directors has the responsibility for a fund's valuation policy and that the SEC expects directors or their equivalent to exercise independent, objective oversight and judgment with respect to execution of the policy and related valuation and pricing procedures. Because traditional investment firm directors carry clear responsibility for valuation, this governance responsibility normally resides with the board or a valuation committee of the board. This board committee would establish the valuation policies and procedures to be executed by fund management or others and normally would review the adequacy of the valuation procedures and the accuracy of valuation results.

Observations

Seventy percent of respondents indicated that the valuation committee has ultimate oversight of the valuation process. This response is consistent with general industry practice and with our expectations. While the board is ultimately responsible for the valuation process, often it will look to the valuation committee to execute the overall policies.

Ensuring consistency of valuation

Is there a process in place for management to compare, identify and document when similar securities are priced differently within the fund complex?



PwC point of view

Generally, using values consistently across all investment products protects the organization against charges that it favors one group of stakeholders over others. In some instances, though, different values can be justified. For example, the SEC has recognized that two boards overseeing mutual funds within a fund complex managed by the same (or affiliated) advisers could arrive at different good faith valuations for the same security. Additionally, some funds within a complex may value securities at a bid price while others value securities at a price between bid and ask. Furthermore, in some cases, affiliates that do not otherwise coordinate trading activity may access different markets for the same security or value their portfolios at different times. In others, unique mandates written into an offering document to meet the needs of a certain investor or investors may cause unusual challenges in determining valuations.

While these situations might justify different valuations, they do not occur often, and differences are particularly difficult to justify when the same portfolio managers and traders are responsible for buying and selling positions across multiple products. In any case, the greater consistency in valuation procedures arising from the application of ASC 820 (formerly FAS 157) is likely to minimize the occurrence of such instances. Therefore, asset managers should consider promoting consistent pricing policies across their organizations and foster a sense of awareness and urgency, particularly among those who are responsible for valuing portfolios and calculating net asset values.

Observations

Although 63% of respondents have the requisite policies in place to ensure compliance, it is a good idea to monitor and test the quality of the process used to implement the policies. Simply relying on the existence of a policy may not be sufficient, as policies are not always followed or may become inadequate when new products are created. Therefore, companies need a way to compare results of the monitoring process and to understand why differences in valuations are justified. These differences, and reasons for them, can be communicated across business units and with senior management and boards for their review and approval. Communicating differences in valuation across the organization quickly will ensure that reviewers have the information they need to justify the differences.

Resources performing valuation

Do you believe the group performing the pricing procedures has the appropriate level of resources, skills, and experience?

PwC point of view

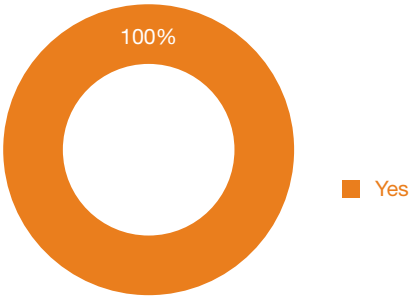
Members of the IPV group (e.g., product controllers, risk managers, valuation experts, and qualified accountants) should have the appropriate knowledge and significant on-the-job experience as well as specialist training.

Observations

Though 89% of respondents feel they have the appropriate resources to perform pricing procedures, management may want to reassess resource needs periodically. Portfolios are becoming more complex and over time could require new skills.

The valuation committee

Do you have a committee specifically responsible for the management and oversight of the valuation policies and procedures, e.g., Valuation Committee?



PwC point of view

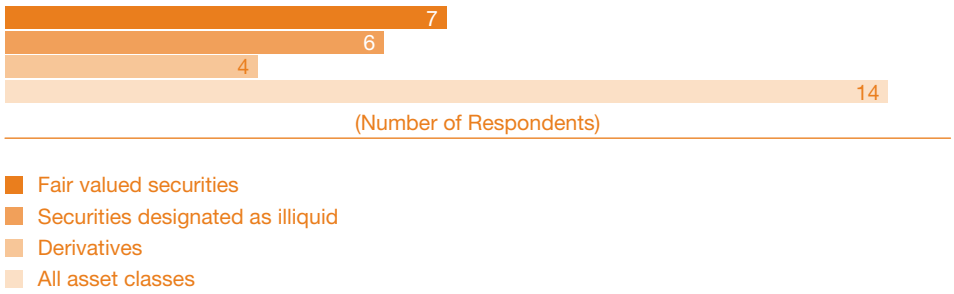
Consideration should be given to assigning a senior management group responsibility for managing and overseeing control and valuation policies and procedures. This group would report the results of its work directly to the board of directors or the audit committee. Members may include representation from market risk management, credit risk management, financial control/ product control groups, senior business management, tax, legal and compliance. This group would prepare and review documentation and, where relevant, the board of directors or the audit committee would be involved in the approval of fair values.

Observations

Valuation committees have become commonplace among traditional investment companies, and evidence of this trend was found in the survey results. All of the traditional fund respondents indicated they have a committee responsible for the management and oversight of valuation policies and procedures. As the responses to other survey questions suggest, the industry differs with respect to the responsibilities imposed on these committees.

Asset classes reviewed by the valuation committee

What asset classes is the Valuation Committee responsible for reviewing? Select all that apply.



PwC point of view

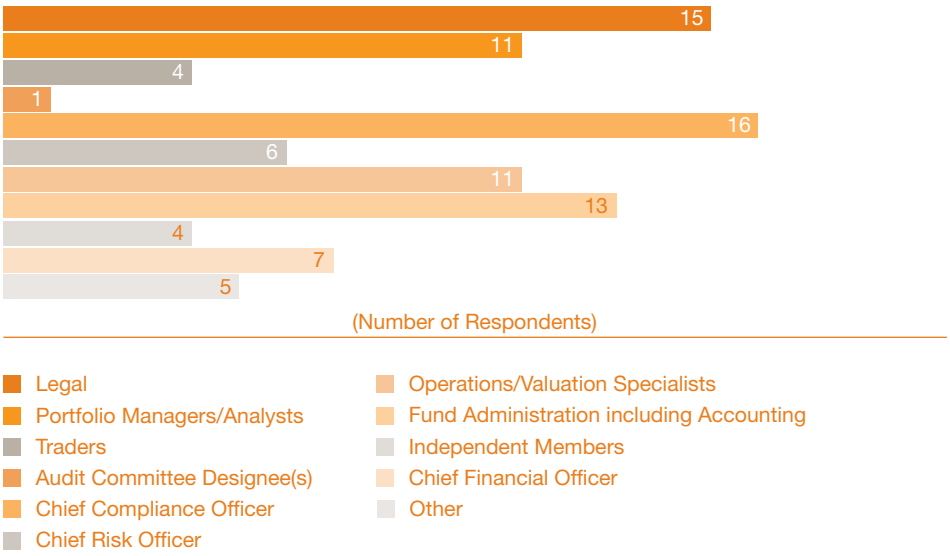
It is important for the board to ensure that valuation policies and procedures are established and include factors for determining the fair value of all applicable securities. While there continues to be debate and diversity in practice with respect to what asset classes are reviewed by the valuation committee, we believe that there is an inherent risk in limiting the scope of the valuation committee in the valuation process.

Observations

The survey results indicate a divergence in practice on this point. The majority of asset managers review all asset classes, which is in line with our point of view, but some respondents seem to focus mainly on certain "riskier" asset classes. We believe that there is an inherent risk in limiting the scope of the valuation committee. Ultimately the valuation committee is an extension of the board or audit committee and, as such, must ensure that proper controls exist around all asset classes to be effective in carrying out their responsibilities.

Composition of the valuation committee

What is the composition of the Valuation Committee?
Select all that apply.



PwC point of view

Independence, accountability, and segregation of duties are important organizational concepts that effective boards and managers embrace. Management's valuation committee, as noted earlier, normally consists of senior managers with responsibility to resolve valuation questions and exercise oversight responsibilities covering the pricing vendors, administrators, and fund personnel involved in the valuation process. To reduce the potential for management bias, it is desirable for voting members of the valuation committee to be independent of the portfolio management function. Investment managers and traders may provide input to the committee but are advised not to serve in a decision-making role.

In our experience, the CCO or chief risk officer (CRO) typically does not serve in a decision-making capacity, more often attending valuation committee meetings to observe and ensure that the process is performed in accordance with approved valuation policies and procedures. Organizationally, it is often more appropriate to separate CCOs from valuation-related operational roles so that they are not conflicted in reporting on compliance processes in which they actively participated.

It is important that valuation committees bring objectivity and good judgment to the deliberations and recognize that their charge is to be fair to all stakeholders, not to always seek the highest valuations (or, equally, not to be overly conservative).

Observations

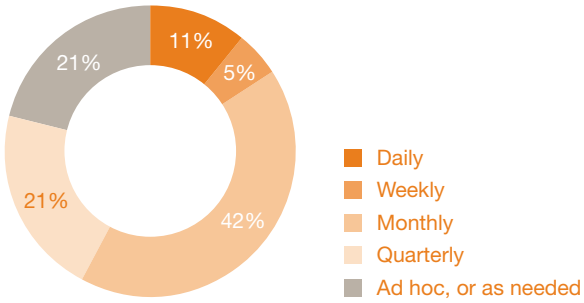
The three members of the valuation committee most commonly cited by respondents (legal, compliance, and fund administration) meet the SEC's expectations for "persons independent of the investment management." However, respondents who identified portfolio managers/analysts (the fourth most commonly cited committee member) would do well to evaluate whether this group is sufficiently independent with respect to the valuation process.

Generally, a lower than expected number of respondents indicated the presence of independent members on their valuation committees. Respondents may want to consider whether their valuation process meets their own expectations for independence, as well as the expectations of regulators. For example, firms may want to reconsider the voting status of portfolio personnel serving on valuation committees, particularly in situations where these personnel are valuing securities in which they have investment management responsibility.

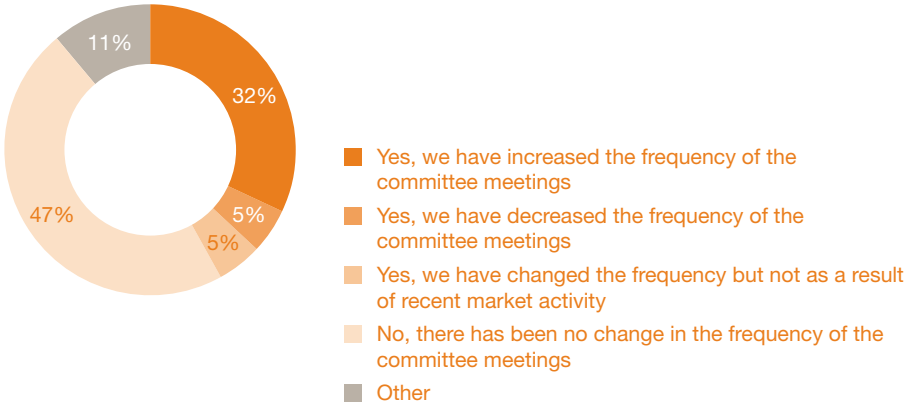
Captured in the "Other" category, a few respondents noted that valuation committee members included interested board members, the treasurer, the head of funds, internal audit, the chief accounting officer, the chairman/CEO, and the chief information officer.

Frequency of valuation committee meetings

How often does the Valuation Committee meet?



Has the frequency of the Valuation Committee meetings changed as a result of the recent market illiquidity/volatility?



PwC point of view

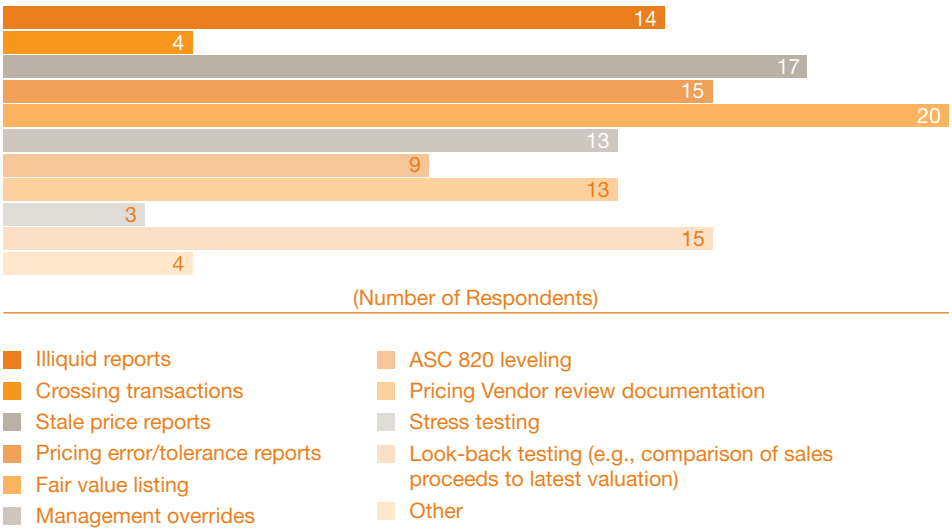
How often a committee meets is not as important as ensuring that the group meets as often as is appropriate. For example, when markets become more volatile, as we have seen in the past two years, and observable valuation inputs from market transactions become increasingly scarce, the committee might meet more frequently to determine how to provide the needed oversight.

Observations

Survey results indicate diversity in the frequency of valuation committee meetings. When respondents assess whether they are meeting either too often or too infrequently in comparison to their peers, they might consider the state of the market and of their portfolios. For example, if there is significant dislocation in the market and meeting frequency has not increased even temporarily, respondents can assess whether they are meeting often enough to properly manage the increased risk in the portfolio values. This is especially significant given that 47% of respondents noted their firms have not adjusted the frequency of meetings as a result of market volatility.

Reports and analyses provided to the valuation committee

What analyses/documentation is provided to the Valuation Committee by the pricing group? Select all that apply.



PwC point of view

In well-governed traditional funds, the following controls, processes and reports are in place and can serve as the basis for reporting to the valuation committee:

- A control to review pricing sources and vendors
- An independent review of securities requiring manual input
- A control to monitor each security's price changes from the previous day for reasonableness
- A control to periodically compare primary to secondary sources
- A stale price review mechanism
- A report to compare portfolio sales to the previous day's valuations
- A form of "look-back" testing, particularly for foreign securities to which a fair value factor has been applied
- A control to identify "significant events" that effect market prices

Observations

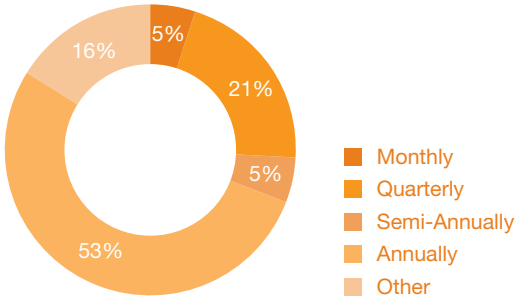
The top four analyses and documentation that respondents provide to the valuation committee are the fair value listing, stale price reports, pricing error reports, and look-back testing. Notably, few respondents use crossing transactions reports. It is worth assessing if this is due to a lack of oversight and whether it is appropriate to use such reports, given the need for a strong control environment to effectively manage crossing transactions.

Comprising the "Other" category, ten respondents provide the following analyses and documentation to the valuation committee:

- Defaulted list of bonds
- Broad market fair value statistics
- Minutes of quarterly and ad-hoc valuation committee meetings
- Money market deviation
- International fair valuation back testing results
- Manually priced securities
- Trade impact report
- Scorecards (pricing and broker data)
- Cross analysis trade testing versus other control exceptions
- Rule 2a–7 money market reports
- Single-sourced, broker and vendor analysis for source change approvals
- Additional analysis on sector or asset classes (such as interest-only, high-yield bonds, and sub-prime loans)

Frequency of procedure reviews

How often does the Chief Compliance Officer/Chief Risk Officer review the valuation policies and procedures to ensure that they are effective and being adhered to?



PwC point of view

The CRO or CCO, along with financial and accounting managers, can play important roles in developing the monitoring controls and mitigating valuation risks. Some asset management firms conduct sessions to identify potential valuation risks, determine how to control the recurring risks, and develop plans to address risks that could occur unexpectedly, such as a significant event.

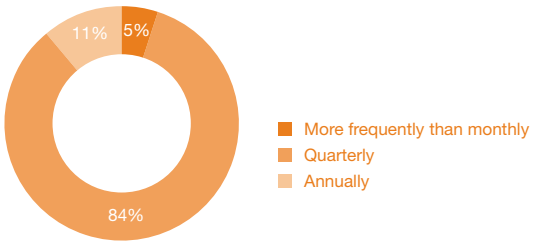
Observations

In most cases, the CCO or CRO is responsible for continuously ensuring that policies and procedures are effective and adhered to by personnel. Fifty-three percent of respondents indicated that their policies are reviewed annually. Whether annual reviews are sufficient will depend to a large extent on the complexity of the investments.

Represented in the "Other" category, a few respondents noted that the compliance function is involved in the valuation process on an ongoing basis. In addition, a small number noted that compliance is involved as needed, such as when a new type of security or investment is acquired.

Frequency of reporting findings of the CCO/CRO to the board

How frequently are findings of the CCO/CRO reported to the Board or Audit Committee?



PwC point of view

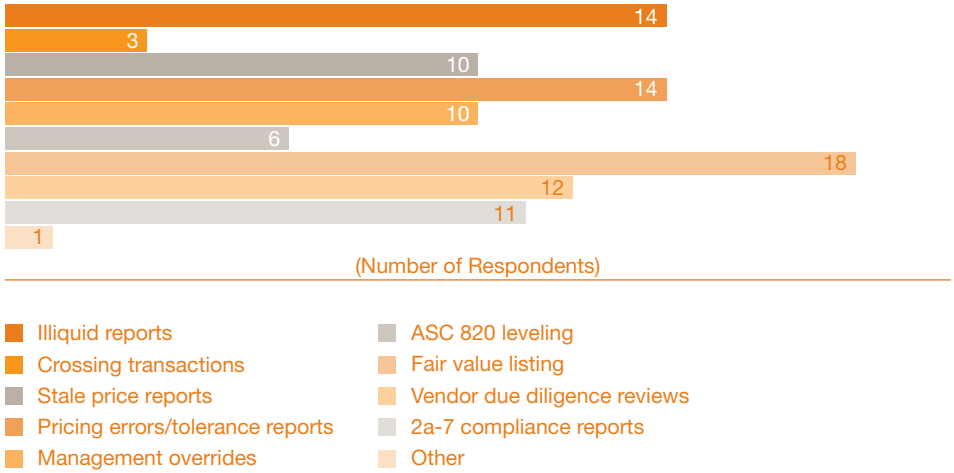
An asset management firm's CRO or CCO can help to determine how often reportable matters are communicated to senior management and boards. In a dynamic organization, reporting may be required more often than annually. Ideally, reporting processes will be reviewed for continual improvement opportunities, to stay abreast of difficult valuation situations and maintain the effectiveness of controls as circumstances change.

Observations

Eleven percent of respondents indicated that findings are reported to the board or audit committee annually. Whether this is often enough depends largely on the structure of the organization and types of investments as well as the volatility of the markets. Notably, 84% of organizations update their boards or audit committees on a quarterly basis. This may reflect the market volatility over the last few years and attempts by organizations to keep pace with market changes.

Reports and analyses provided to the audit committee/board

What valuation analyses/documentation is provided to the Audit Committee/Board? Select all that apply.



PwC point of view

As a starting point, the following information should be included in the reporting package provided to the audit committee/board:

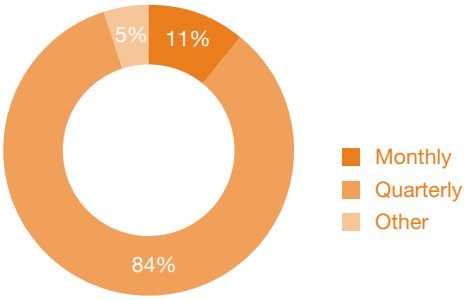
- Results of independent price verification, outliers, and exceptions compared to variance thresholds
- Discussion of fair valued and difficult to price securities
- External fair value disclosures that adequately describe risk and other salient factors
- Clear documentation summarizing the investment valuation approach applied and key assumptions
- Results of vendor due diligence

Observations

Survey responses indicate that the information provided to audit committees/boards is largely consistent. This suggests that boards are well informed, with sufficient data to manage their fiduciary responsibilities. Management might consider periodically reviewing new analyses or reports provided to the valuation committee and determine the appropriateness of providing similar reports to the board.

Frequency of providing analyses to audit committee/board

How frequently are these analyses provided to the Audit Committee/Board?



PwC point of view

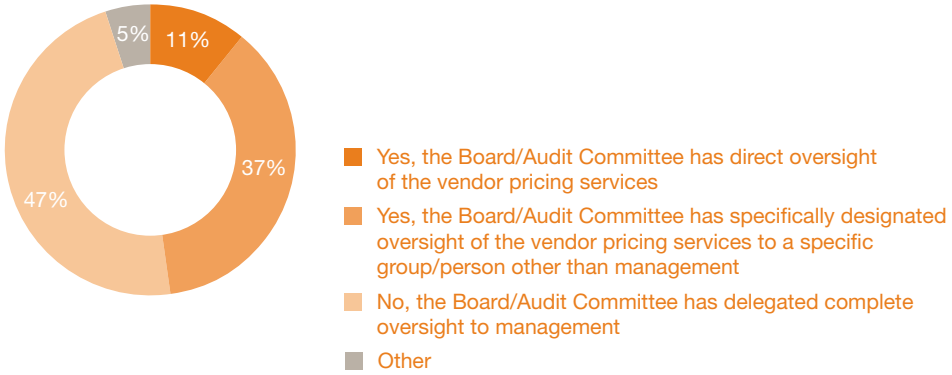
An important component of the valuation process is to provide analyses to the audit committee/board in a timely manner, enabling these groups to properly execute their oversight responsibilities.

Observations

The required frequency of analyses depends on the structure of the organization and types of investments as well as the volatility of the markets. In all cases, organizations said they are providing analyses more often than annually, which we would expect in such a volatile market.

Monitoring pricing service providers

Does the Board/Audit Committee or their approved designees have independent and direct oversight of the vendor pricing services hired for the funds?



PwC point of view

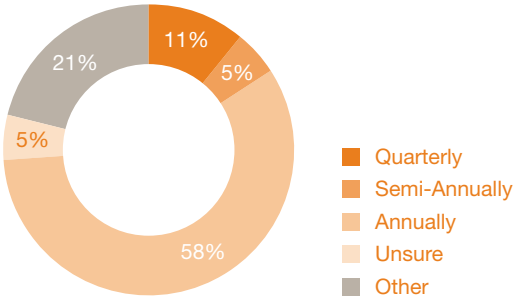
The day-to-day responsibility for monitoring pricing service providers rests with a fund's management team. However, because the directors of traditional investment firms hold a clear responsibility for valuation, this governance responsibility normally resides with the board or a valuation committee of the board.

Observations

Forty-seven percent of respondents noted that the board has delegated complete oversight of pricing service providers to management. Because regulators expect boards to retain ultimate oversight responsibility, it is important that firms which delegate this task to management keep their boards informed of the results. In addition, independent oversight of the pricing service will assist in shielding the valuation process from management bias.

Frequency of board review of vendor pricing services

How frequently does the Board/Audit Committee or their designee review and approve the vendor pricing services?



PwC point of view

To ensure proper oversight, firms may want to consider implementing formal assessments of pricing service providers annually, using consistent criteria and metrics to rate the vendors. It is good practice to retain documentation of these reviews, to support conclusions made and actions taken. Periodic reviews might involve the following:

- Comparing service providers' valuations to those of other pricing vendors and sources
- Conducting site visits to understand service providers' controls
- Corresponding with others in the industry to determine quality of service

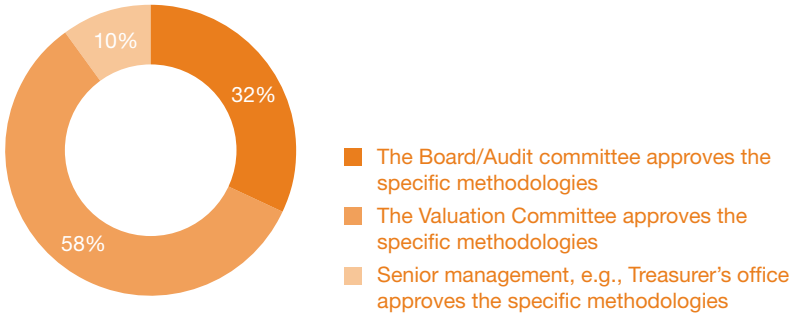
It also may be helpful to know the service provider's regulatory history.

Observations

Fifty-eight percent of respondent organizations perform assessments on an annual basis (the minimum appropriate frequency). A few respondents (represented in the "Other" category) said that reviews are performed as needed or when changes or additions are made to vendor pricing services.

Approval of valuation methodology

Who approves the specific methodologies for how security types should be valued?



PwC point of view

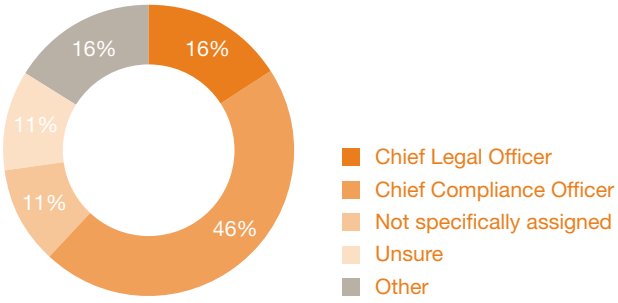
Traditional asset managers may want to consider giving the board of directors or the audit committee responsibility for approving a high-level framework for accounting and valuation. Significant changes to accounting and valuation methodologies should be reported to the board of directors or the audit committee. Responsibility for the design of detailed accounting/valuation methodologies may be given to a senior management group.

Observations

Only 32% of boards approve specific methodologies for valuing securities. The SEC has indicated that boards that are not involved in approving such methodologies must have a commensurate level of involvement in the daily valuation process to satisfy their good faith obligation. This obligation can be met if the board periodically reviews the appropriateness of the methods used to value securities and the quality of the prices obtained through these procedures, and makes changes when appropriate. For the 11% of respondents that have delegated approval of valuation methodologies to senior management, SEC requirements dictate that the board's involvement should be greater and more immediate.

Monitoring compliance of disclosures

Who monitors compliance with disclosures made to the Board and investors?



PwC point of view

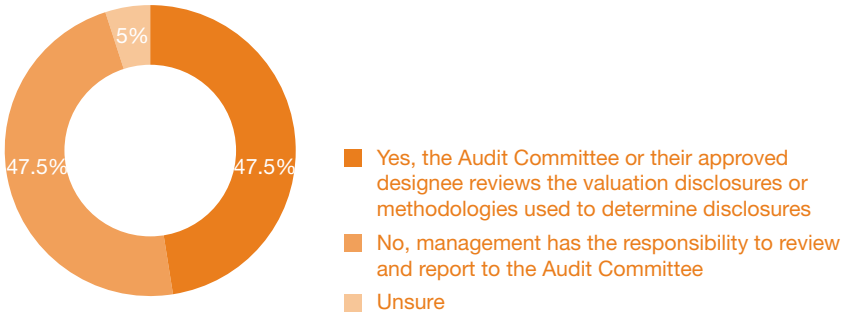
A fund's CCO is responsible for monitoring the effectiveness of its compliance policies and procedures as well as monitoring compliance of the fund's service providers. Periodic testing of procedures can help to determine whether they are designed adequately and operating effectively.

Observations

Forty-seven percent of respondents identified the CCO as being responsible for monitoring compliance with disclosures made to the board and investors. While CCOs are not expected to be valuation experts, they are expected to address the fair valuation process as part of their testing and reporting responsibilities. As a result, CCOs should consider whether public disclosures concerning fair valuation are consistent within the organization and whether there is a process in place for timely board reporting and review of fair value matters.

Review of financial statement disclosures

Does the Audit Committee or a committee-approved designee (other than fund administration) review the financial statement disclosures relative to the valuation process, (e.g., ASC 820 levels)?



PwC point of view

The board should consider leveraging the CCO, management, the adviser, and service providers to assist with oversight responsibilities. This effort may include obtaining regular updates in such areas as regulatory compliance, financial reporting, accounting, and legal matters.

Observations

Regardless of whether management is designated to review financial statement disclosures, it is important that the board or audit committee obtain regular updates on such matters. Respondents were almost evenly split between funds that do or do not give management responsibility for reviewing disclosures. Either scenario is appropriate as long as there is proper board oversight.

Conclusion

Traditional registered investment funds face a number of valuation risks—most prominently, market volatility and changing liquidity as well as concerns over the reliability of data provided by pricing sources. All of the firms we surveyed have a valuation committee in place to manage and oversee valuation policies and procedures, but some respondents may want to consider the makeup of their committees in order to ensure that they meet expectations for independence and objectivity.

According to the survey results, the information given to the boards and valuation committees is largely consistent, which suggests the boards are well informed and have the data they need to execute their fiduciary responsibilities. The majority of respondents are updating their boards on a quarterly basis—a sound approach for any firm that is striving to navigate in a volatile marketplace that continues to change rapidly.

Alternative investment firms

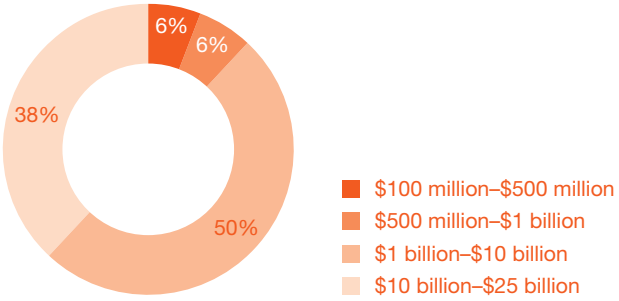
Survey results by sector

Introduction

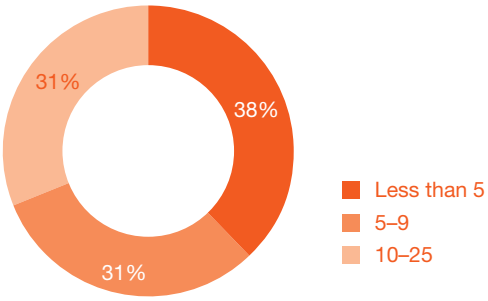
PwC surveyed alternative investment firms that manage from $100 million to $25 billion in assets. On the following pages we provide an overview of the survey findings, details of participants' responses to each of the 20 questions we posed, on topics ranging from the key valuation risks to the review of financial statement disclosures, and our point of view on each topic.

Participant statistics

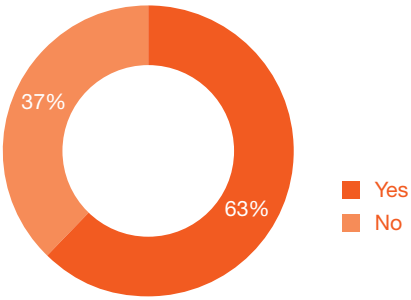
What are the assets under management (both registered and non-registered)?



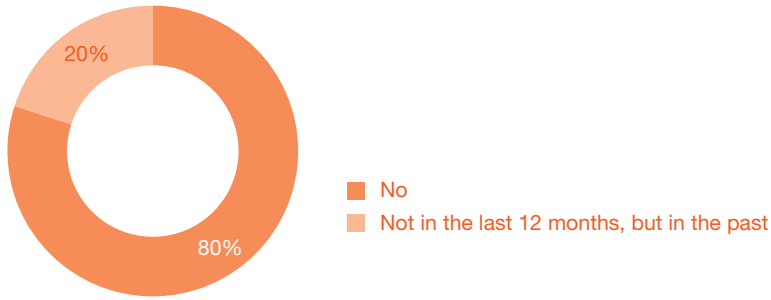
What is the number of funds under management (both registered and non-registered)?



Is the Adviser registered with the SEC?



Has the fund complex been subject to a sweep examination by the SEC on valuation in the last 12 months?



Overview of roles and survey findings

The following is an overview of the role of management, the valuation committee, and the board (or its equivalent) of alternative investment funds, as well as their oversight of valuation disclosure activities. Responses to individual survey questions, and PwC's perspective on those responses, follow (see "Survey results").

The role of management

In all asset management firms, management is responsible for the day-to-day operations of the funds it oversees, including the selection and oversight of key service providers, regardless of the funds' legal structure or regulatory oversight. Management is also responsible for the pricing and valuation process for fund securities. This process involves identifying the valuation risks implicit in the firm's investment strategy and creating a series of controls to seek to mitigate and manage these risks. Such mitigation has become much more difficult with growing complexity in investment strategies, market volatility, changing transparency requirements, decreasing observable inputs in trading activity, and increasingly cautious pricing vendors and broker-dealers.

Like their traditional fund counterparts, most alternative asset managers surveyed (81%) identified market volatility and changing liquidity as the most prevalent valuation risk. However, only 37% said they are concerned about reliability of data from established external pricing sources. They are focused more on the information obtained from portfolio managers in estimating fair value (56%) and the risk associated with single sources, such as brokers or counterparties (50%). This difference is not surprising, given the greater complexity of the investment strategy of many alternative funds compared to traditional funds.

Alternative firms, like their traditional counterparts, were split on the use of an internal group to price illiquid or difficult-to-price securities. Sixty-three percent of alternative fund respondents do not have such a group in place. Among those that do, the most significant difference between traditional and alternative funds centers on responsibility for oversight of the pricing group. In traditional funds, the valuation committee is responsible for oversight, according to the survey. Among alternative fund respondents, half say the pricing group reports to the chief financial officer (CFO).

The role of the valuation committee

It appears that the use of the valuation committee or its equivalent is becoming the norm, regardless of the sector. As noted earlier, all traditional fund respondents have such a committee. So do almost all (94%) of the alternative asset managers we surveyed.

In alternative more so than traditional funds, finance personnel play a significant role in the valuation process. The CFO was identified as a valuation committee member by 88% of respondents, compared with 38% for traditional asset managers. Legal and compliance are represented on the committees as well, but to a lesser extent than in traditional fund committees. However, alternative funds have more diverse representation, including operations, finance, and trading personnel.

The difference in composition of valuation committees between traditional and alternative asset managers could be attributable mainly to the size and structure of the organizations. Alternative asset managers tend to be smaller organizations that rely more heavily on the CFO to monitor the valuation process and to have operations and trading personnel more involved in the process. By contrast, traditional asset managers have more structure and can accomodate having certain personnel focused on the valuation process.

While it is not surprising that alternative asset managers rely more heavily on finance and trading personnel to be involved in valuations, care should be taken to ensure that the valuation committee maintains an independent outlook. For instance, if the committee is relying solely on the views of the CFO in determining the appropriate valuations of investments, this practice may need to be modified going forward.

Regulatory pressures and changing market dynamics could influence how the valuation committees of alternative funds are structured in the future. Over time, we may see a decline in the differences in the composition of such committees across all sectors of the asset management industry.

As with traditional funds, market volatility did not drive a significant increase in valuation committee meetings for alternative managers. Only 13% of alternative asset managers (compared with 37% of traditional fund respondents) identified volatility as a reason to change the frequency of their meetings.

There is significant variation in the types of materials alternative funds provide to their valuation committees, compared to the materials provided by traditional asset managers. For example, more than 70% of traditional asset managers provide a stale pricing or illiquid securities report to the valuation committee, but less than 35% of alternative asset managers do so. This finding is particularly interesting when you consider that illiquidity was the most prevalent risk cited by both alternative and traditional asset managers.

We also found a lack of consistency among alternative asset managers in terms of the quantity of reports they deliver to the valuation committee. Of 16 possible reports, only six were provided to the committee more than 50% of the time.[1] (We found similar inconsistency at traditional asset managers: seven of the 11 possible reports were provided to the committee more than 50% of the time.[2])

The role of the board or its equivalent

Notably, 19% of respondents indicated they do not have a board or its equivalent overseeing the valuation process. Where a board or equivalent does have oversight responsibility, they receive less information than their traditional fund counterparts. Thirty-eight percent of alternative asset managers queried provide no valuation information to their boards, while 13% deliver valuation minutes or other information only on request. The remaining respondents said they provide very few reports, if any. (The most commonly provided report among this group was a summary of the valuation methodology and approach).

As noted previously, oversight of pricing vendors is evenly split among boards and management for traditional funds: roughly half have direct or indirect oversight of the vendors hired, and roughly half delegate oversight responsibility to management. This is not the case for alternative funds; three-quarters of respondents in that sector say their organizations have delegated this responsibility to management.

Oversight of the disclosure process

Thirty-eight percent of alternative asset managers we surveyed do not involve the board in reviewing financial statement disclosures in any capacity. In slightly over half of the organizations (56%), the CFO or chief compliance officer (CCO) is responsible for ensuring compliance with disclosures made to the board and investors.

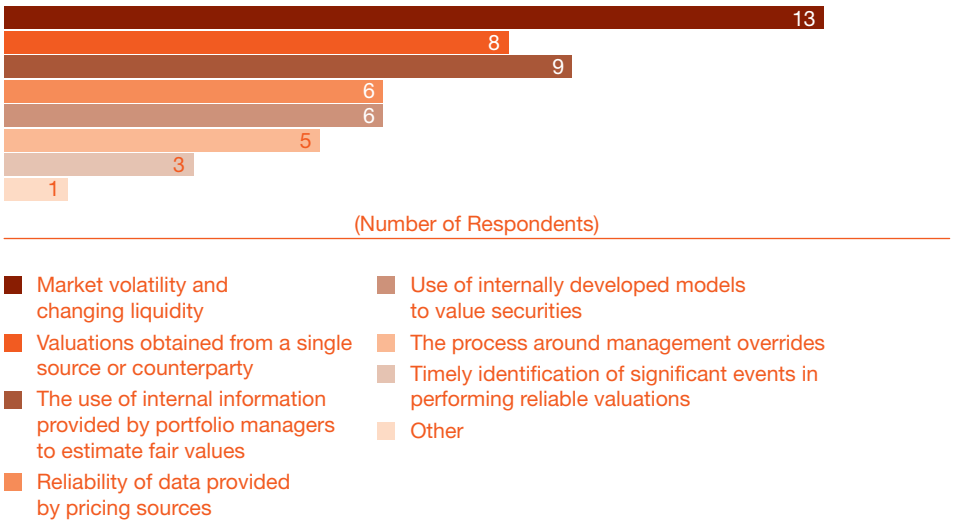
1. The six reports are the fair value listing, ASC 820 leveling, summary of the valuation methodology approach, portfolio company information, third-party valuations prepared by valuation experts, and models used in the valuation process.

2. The seven reports are the illiquid reports, stale price reports, pricing error/tolerance reports, fair value listing, management overrides, pricing vendor review documentation, and look-back testing.

Survey results

Key valuation risks

Which of the following are key valuation risks specific to your organization? Select all that apply.



PwC point of view

A sound valuation process begins with a robust definition of the key valuation risks that senior management and the board or its equivalent agree they need to monitor and mitigate. Once the risks are identified, management can develop controls that monitor and mitigate the risks, and should provide reports to those charged with governance. We believe that the risks noted in the chart above represent key valuation risks for most organizations, and if not appropriately monitored and controlled, significantly increase the potential for error in valuing portfolios.

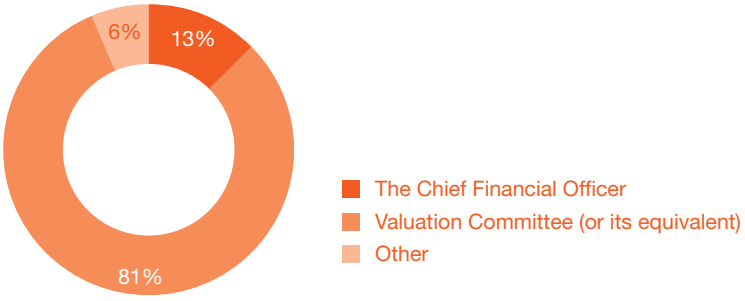
Observations

Market volatility and changing liquidity topped the list of valuation risks, cited by 81% of alternative fund managers surveyed. Other risks cited most frequently include the use of internal information provided by portfolio managers to estimate fair value (57%), and valuations obtained from a single source or counterparty (50%). After these risks, the consistency of responses drops off significantly. In the "Other" category, a small number of respondents noted regional timing and primary markets as key risks.

Similar to traditional asset managers, many respondents in the alternative sector respondents did not identify the process around management overrides as a key valuation risk. Asset managers may want to periodically assess why overrides are occurring, as frequent overrides are often a red flag, indicating that the quality of pricing service valuations has declined or that a bias needs to be addressed. As with other risk management operations, there is no foolproof method to eliminate valuation risks, but the risks can be minimized through the vigilance and oversight of senior management and boards. In an effective organization, these stakeholders never lose sight of the ultimate goal: valuations that treat all stakeholders fairly.

Responsibility for the valuation process

Who in management is ultimately responsible for the valuation process?



PwC point of view

Consideration should be given to assigning a senior management group responsibility for managing and overseeing control and valuation policies and procedures. Members may include representatives from market risk management, credit risk management, financial control/product control groups, senior business management, tax, and legal. This group would prepare and review documentation and, where relevant, the board of directors or the audit committee would be involved in determining and verifying fair values.

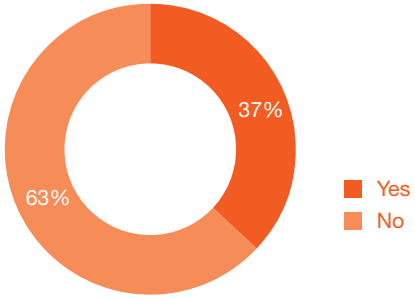
Observations

Eighty-one percent of respondents identified the valuation committee as having ultimate responsibility for the valuation process. This role is appropriate because it allows for some degree of independence and objectivity through representation from several of the key stakeholders in the organization, rather than one person or the front office. Historically, alternative funds have had less of a formal governance structure in place than traditional funds. This could be changing, as evidenced by the fact that the majority of respondents do have some governance process in place with respect to valuation. This is not surprising, given both the current and anticipated regulatory and investor demands.

Captured in the "Other" category, a small number of respondents noted that a subgroup of partners within the firm was responsible for valuation.

Independent price verification

Is there a pricing group that is responsible for pricing illiquid or difficult to price securities?



PwC point of view

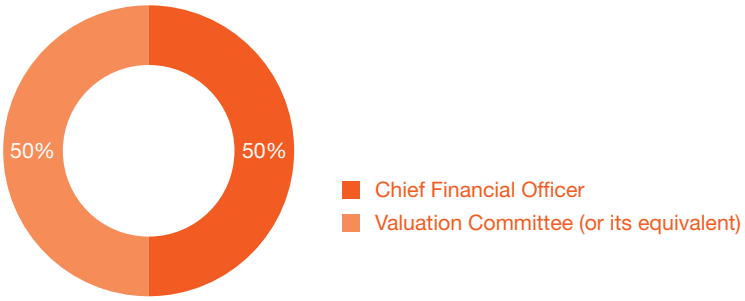
Firms may want to consider having an appropriately qualified and experienced independent price verification (IPV) group be responsible for determining the fair value of securities. Where fair value is a critical component of reported results, the IPV group can have dedicated quantitative professionals within the financial control or risk management group to deal with complex price verification issues. A key component of the IPV group's work is to verify the pricing model, independent of risk-taking activities, using highly experienced and qualified quantitative professionals.

Observations

Nearly two-thirds of respondents said they do not yet have an IPV group in place. Depending on the complexity of their investment strategies and volume of securities involved, this model might be appropriate. That said, firm management may want to monitor the evolving complexity of investment strategies and determine whether a dedicated IPV group is necessary. If we assume that alternative funds generally have more complex strategies than traditional funds, an IPV group would be a wise addition to the governance process.

Oversight of the valuation process

Who does the pricing group report directly to?



PwC point of view

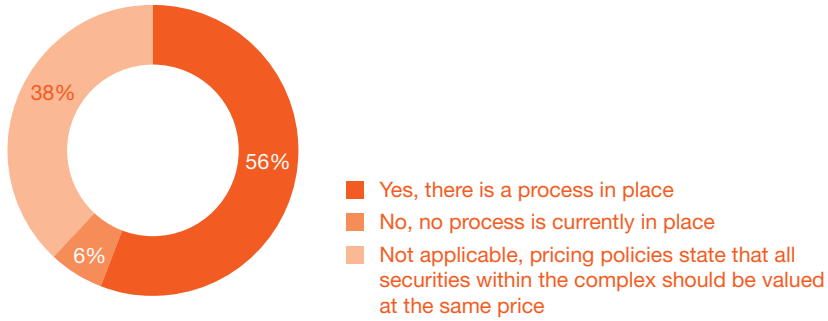
With respect to oversight of the valuation process, the SEC has indicated that those charged with governance are responsible for a fund's valuation policy. The SEC also expects directors or their equivalent to exercise independent, objective oversight and judgment with respect to execution of the policy and related valuation and pricing procedures. The SEC has stated directors are responsible for valuation, and this governance responsibility normally resides with the board or the board's valuation committee. This board committee would establish the valuation policies and procedures for execution by fund managers and pricing services and would review valuation results on a timely basis.

Observations

Half of respondents stated that the valuation committee has ultimate responsibility for oversight of the valuation process, while the other half indicated this responsibility falls with the CFO. This response is consistent with general industry practice and our expectations, since many alternative funds may not have a board of directors. However, this governance model is subject to change as alternative fund managers consider their infrastructure when entering the registered investment s/b adviser space.

Ensuring consistency of valuation

Is there a process in place for management to compare, identify and document when similar securities are priced differently within the fund complex?



PwC point of view

Consistent use of values across all investment products protects the organization against charges that it is favoring one group of stakeholders over others. In some instances, though, different values can be justified. For example, the SEC has recognized that two boards overseeing mutual funds within a fund complex managed by the same (or affiliated) advisers could arrive at different good faith valuations for the same security. Additionally, some funds within a complex may value securities at a bid price while others use a price between bid and ask; affiliated advisers that do not otherwise coordinate trading activity may access different markets for the same security or value their portfolios at different times; or unique mandates written into an offering document to meet the needs of a certain investor or investors may create unusual challenges in determining valuations. However, these situations do not occur often, and they are particularly difficult to justify when the same portfolio managers and traders are responsible for buying and selling positions across multiple products.

The greater consistency in valuation procedures arising from the application of ASC 820 (formerly FAS 157) is likely to make these instances even less likely to occur. Therefore, asset managers need to promote consistent pricing policies across their organizations and foster a sense of awareness and urgency, particularly among those responsible for valuing portfolios and calculating net asset values.

Observations

Although 56% of respondents have the requisite policies in place to ensure compliance, they may want to monitor and test the quality of the process used to implement the policies. Simply relying on the existence of a policy may not be sufficient, as policies are not always followed or may become inadequate when new products are created. Therefore, asset managers need a way to compare results of the monitoring process and to understand why differences in valuations are justified. Communicating any differences in valuation across the organization quickly will ensure that reviewers have the information they need to justify the differences.

Resources performing valuation

Do you believe the group performing the valuation procedures has the appropriate level of resources, skills, and experience?

PwC point of view

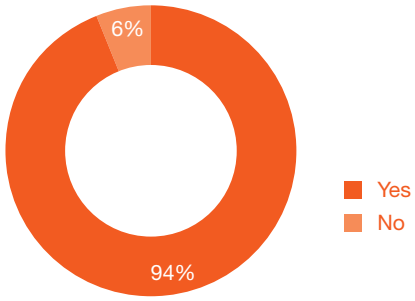
As noted earlier, members of the IPV group (e.g., product controllers, risk managers, valuation experts, qualified accountants) should have the appropriate knowledge and significant on-the-job experience as well as specialist training.

Observations

Although 88% of respondents feel they have the right resources to perform valuation procedures, management may want to reassess resource needs periodically. A few respondents noted that while their valuation resources had the appropriate skills, there was a need for more resources. Portfolios are becoming more complex, and over time could require new skills.

The valuation committee

Do you have an investment, valuation or similar committee to review valuations?



PwC point of view

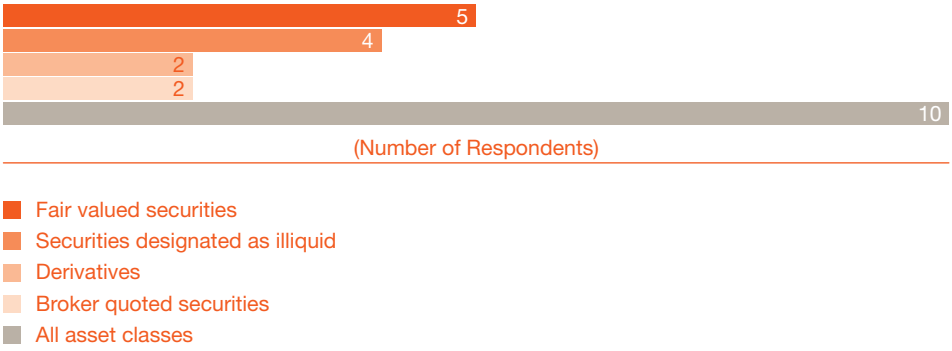
Leading firms typically give a senior management group responsibility for the management and oversight of control and valuation policies and procedures. Members may include representatives from market risk management, credit risk management, financial control/ product control groups, senior business management, tax, and legal. Proper and complete documentation may be prepared and reviewed by senior management and, where relevant, by the board of directors or equivalent for those processes related to the approval of fair values.

Observations

Valuation committees have become a commonplace part of the valuation process: almost all respondents (94%) indicated that their firms have such a committee in place. This response is encouraging, because some alternative firms are not registered. As the responses to the later related questions suggest, the industry differs with respect to the responsibilities imposed on these committees.

Asset classes reviewed by the valuation committee

What asset classes is the Valuation Committee responsible for reviewing? Select all that apply.



PwC point of view

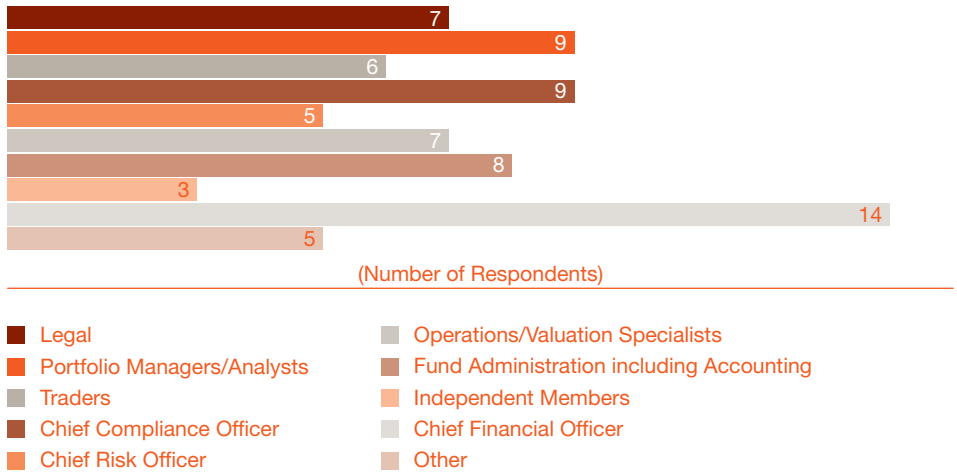
It is important for the board to ensure that valuation policies and procedures are established and include criteria for determining the fair value of all applicable securities. While there continues to be debate and diversity in practice with respect to what asset classes are reviewed by the valuation committee, we believe that there is an inherent risk in limiting the scope of the valuation committee in the valuation process.

Observations

The survey results indicate a divergence in practice on this point. The valuation committees of the majority of respondents review all asset classes, which is in line with our point of view. On the other hand, some respondents seem to focus mainly on certain "riskier" asset classes. Ultimately, the valuation committee is an extension of the board or its equivalent, and as such, is responsible to ensure that proper controls exist around all asset classes.

Composition of the valuation committee

What is the composition of the Valuation Committee? Select all that apply.



PwC point of view

To reduce the potential for management bias, it is desirable for voting members of the valuation committee to be independent of the portfolio management function. For example, while investment managers and traders may provide input to the committee, it may not be appropriate for them to serve in a decision-making role. In our experience, the CCO or chief risk officer (CRO) typically does not serve in a decision-making capacity but more often attends valuation committee meetings only to observe and ensure that the process is performed in accordance with approved valuation policies and procedures.

It is often more appropriate to separate CCOs from valuation-related operational roles so they do not face a conflict of interest in reporting on compliance processes in which they actively participated. It is important that any valuation committee member bring objectivity and good judgment to the deliberations and recognize that the charge is to be fair to all stakeholders, not to always seek the highest valuations (or, equally, to not be automatically conservative).

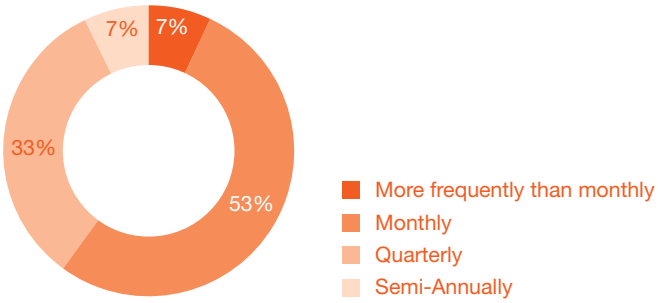
Observations

Many respondents indicated that their valuation committees include representatives of legal, compliance, and fund administration which is a positive trend given the independence expectations of regulators. Portfolio managers/analysts also seem to be prominent on the valuation committees of alternative funds, most likely because of their role in making investment decisions. Respondents that identified these investment personnel as committee members may want to consider if these members are sufficiently independent of the valuation process particularly if those personnel are voting members of the committee. Along the same lines, a lower than expected number of asset managers indicated the presence of independent members on their valuation committees. These respondents may want to consider whether their valuation process meets their own expectations for independence, as well as the expectations of regulators.

Finally 88% of respondents indicated that the CFO sits on the valuation committee. Respondents who indicated “Other” noted that the chief investment officer, chief accounting officer, chief operating officer, and managing partners serve on the committee.

Frequency of valuation committee meetings

How often does the committee meet?



Has the frequency of the Valuation Committee meetings changed as a result of the recent market illiquidity/volatility?

PwC point of view

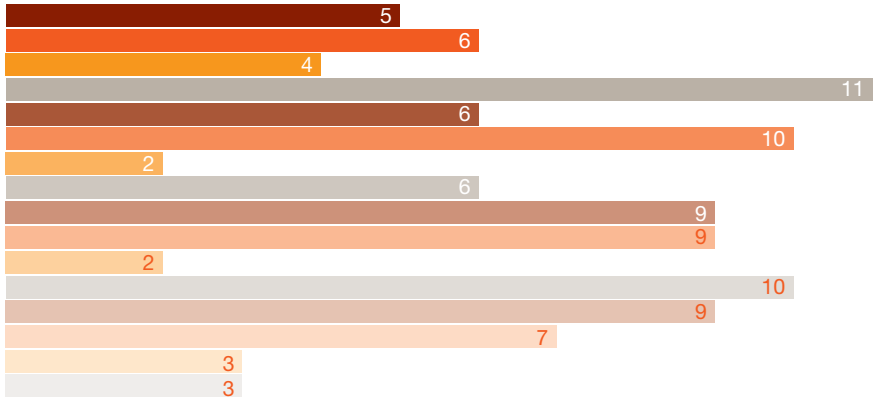
How often a committee meets is not as important as ensuring that the group meets as often as is appropriate. For example, when markets become more volatile, as we have seen in the last two years, and fair valuations increasingly replace prices based on market transactions, the valuation committee may meet more frequently to determine how to provide the needed oversight.

Observations

Survey results indicate diversity in the frequency of valuation committee meetings. When respondents assess whether they are meeting too often or too infrequently relative to their peers, they might consider the state of the market and of their portfolios. For example, if there is significant dislocation in the market and meeting frequency has not increased even temporarily, respondents may want to assess whether they are meeting often enough to properly manage the increased risk in the portfolio values. This is especially significant given that 80% of respondents noted no change in the frequency of meetings as a result of recent market volatility.

Reports/analyses provided to the valuation committee

What analyses/documentation is provided to the Valuation Committee by the pricing group? Select all that apply.



- Illiquid reports
- Stale price reports
- Pricing error reports
- Fair value listing
- Management overrides
- ASC 820 leveling
- Pricing Vendor due dilligence reports
- Look-back testing (e.g., comparison of sales proceeds to latest valuation)
- Summary of the valuation methodology and approach
- Portfolio company information
- Minutes of the underlying portfolio company meetings, e.g., board meetings
- Third-party valuations prepared by valuation experts
- Models used in the valuation process
- Broker quoted securities
- Price challenge report
- Other

PwC point of view

In well-governed alternative funds, the following controls, processes, and reports are in place and can serve as the basis for reporting to the valuation committee:

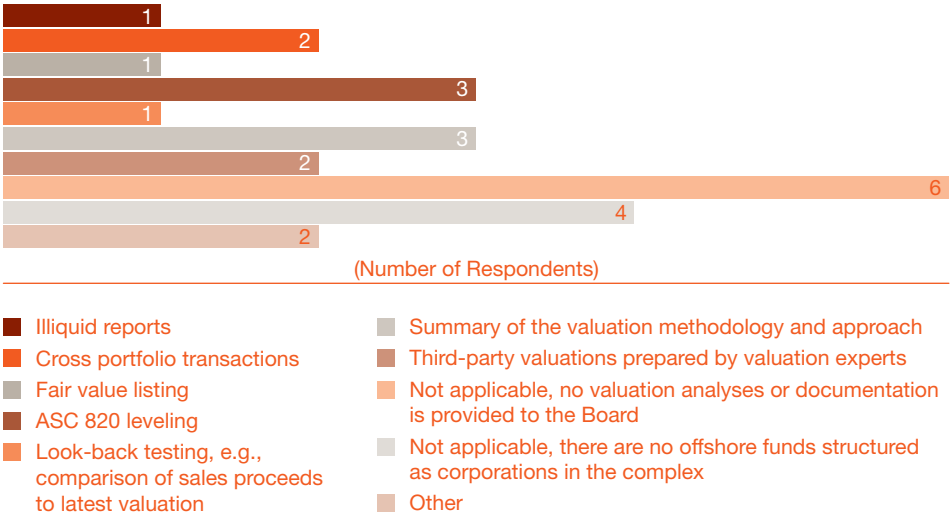
- A control to review pricing sources and vendors
- An independent review of securities requiring manual input
- A control to monitor the reasonableness of each security's price changes from the previous day
- A control to compare primary to secondary sources periodically
- A stale price review mechanism
- A report to "look-back" and compare portfolio sales to the previous day's valuations

Observations

The top three forms of analyses and documentation that respondents provide to the valuation committee are the fair value listing, ASC 820 leveling, and third-party valuations. Closely following are the summary of the valuation methodology and approach, the portfolio company information and models used in the valuation process. Some firms also provide pricing analytics, analysis summaries, and a listing of level 2 and 3 securities, noting their valuation and profit and loss changes in unrealized gains/losses (responses captured in the "Other" category). Although valuation committees already receive a number of reports, they may want to consider other reports, such as price challenges and broker-quoted securities reports, to gain more insight into valuation issues. This is particulary important given that valuations obtained from a single source or counterparty was identified as the third most significant risk.

Valuation documentation provided to the board

For funds where there is an outside Board of Directors, e.g., offshore corporation, what valuation analyses/documentation is provided to the board? Select all that apply.



PwC point of view

As a starting point, the following information is important to include in the valuation documentation package presented to the board:

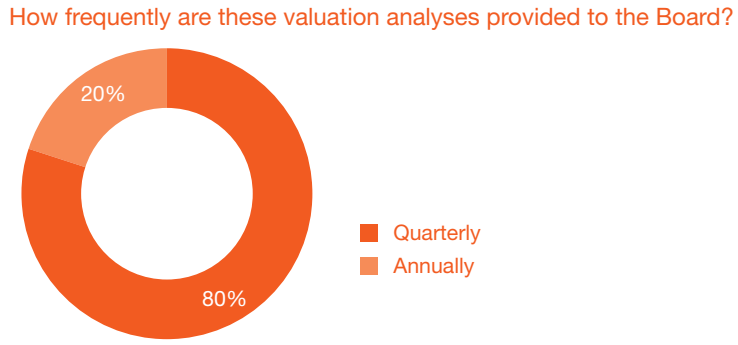
- Results of independent price verification, outliers, and exceptions compared to variance thresholds
- External fair value disclosures that adequately describe risks and other salient factors
- Clear documentation summarizing the investment and valuation approach applied, including key assumptions
- Discussion of fair valued and dificult to price securities
- Results of vendor due diligence review

Observations

Thirty-eight percent of respondents do not provide valuation information to the board of their offshore corporations. This suggests that these boards may not have the same level of transparency to valuation documentation and conclusions when compared the other assets management sectors. This may change in the coming year, as regulation of firm commences.

Offshore boards may want to periodically review new analyses or reports provided to the valuation committee, and they should consider obtaining minutes of committee meetings, to review the decisions made and ensure that the interests of investors are being satisfied. A few respondents do provide their boards with valuation committee meeting minutes, according to "Other" responses received.

Frequency of providing valuation analyses to the board



PwC point of view

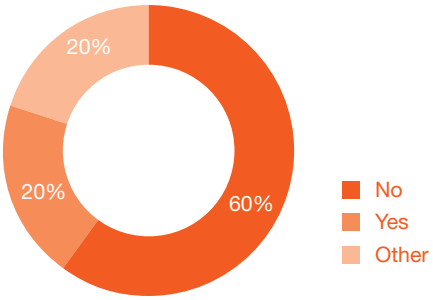
Delivering valuation packages to the board or valuation committee at least annually can help to ensure effective monitoring.

Observations

The required frequency of analyses provided to the board will depend on the structure of the organization and the nature of its investments as well as the volatility of the markets. Eighty percent of respondents provide valuation analyses more often than annually, which we would expect in such an uncertain market.

Risk committees for funds without a board

For funds where there is no outside Board, e.g., Partnerships, is there an enterprise/operational risk committee that acts in a similar capacity to a Board?



PwC point of view

With respect to oversight of the valuation process, the SEC has indicated that the board of directors is responsible for establishing a fund's valuation policy and that the agency expects directors or their equivalent to exercise independent, objective oversight and judgment with respect to execution of the policy and related valuation and pricing procedures. This board committee would establish the valuation policies and procedures for execution by fund managers and pricing services and normally would review valuation results on a timely basis.

Observations

Sixty percent of respondents have no enterprise or operational committee to oversee the valuation of investments. Firms may want to consider having some oversight of the valuation process, even if the structure of the fund is a partnership with no formal board. Captured in the "Other" category, a small number of respondents noted that the board or its equivalent ratified valuations.

The remaining 40% of respondents that noted that they had a committee in place said their committee has a specific mandate over valuation, which aligns with what we view as a trend in the market place driven by the regulator and investors. These respondents supply a number of reports to their oversight committees, in line with material presented to the valuation committee and the board of an offshore fund. However, their committees may also consider other reports, such as price challenges and broker-quoted securities reports, for insight into valuation issues. This group was split on the frequency of providing analyses to the oversight committee; half provide such analyses annually and half provide them quarterly. A key element of the valuation process is the timely delivery of information, to allow the committee to properly execute its oversight responsibilities.

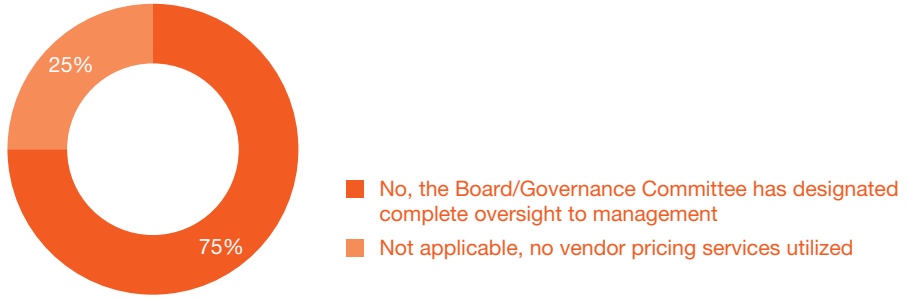
The appropriate frequency of information flow will depend on the structure of the organization and nature of its investments. In all cases, organizations said they are providing analyses more often than annually, which we would expect in such a volatile market.

There was little consistency among respondents concerning the members of the oversight committee. Several types of members cited by respondents (specifically, representatives of legal, compliance, and fund administration) represent a positive trend given the independence expectations of regulators. Portfolio personnel also were identified as members of the oversight committee by some respondents. Firms that identified portfolio personel may want to consider how independent of the valuation process they are. If portfolio personnel remain part of the process, firms might consider making them non-voting committee members. Overall, respondents may want to consider whether their valuation process meets their internal expectations for independence, and the expectations that regulators may seek in the future.

There is variation in the frequency of committee meetings; half of the respondents reported they meet quarterly and the other half, semi-annually. In assessing whether they are meeting too often or too little in comparison to their peers, firms might consider the state of the market and of their portfolios. For example, if there is significant dislocation in the market and meeting frequency has not increased, even temporarily, respondents will have to assess whether their meeting schedule is sufficient to properly manage the increased risk in the portfolio values.

Board oversight of vendor pricing services

Does the Board/Governance Committee or their approved designees have independent and direct oversight of the vendor pricing services hired for the funds?



PwC point of view

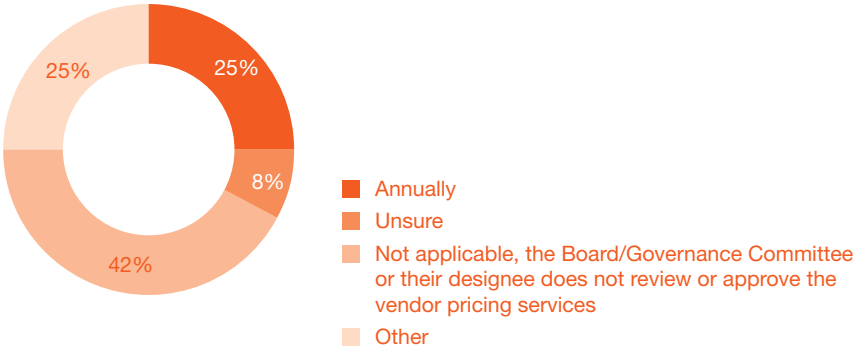
The day-to-day responsibility for monitoring pricing service providers may reside with a fund's management. However, because fund directors hold responsibility for valuation, it is important for governance to reside with the board or a valuation committee of the board.

Observations

Seventy-five percent of respondents noted that the board has delegated complete oversight of vendor pricing services to management. Because regulators expect boards to retain ultimate oversight responsibility, it is important that firms which delegate this task to management keep their boards informed of the results. In addition, independent oversight of the pricing service will assist in shielding the valuation process from management bias.

Review and approval of vendor pricing services

How frequently does the Board/Governance Committee or their designee review and approve the vendor pricing services?



PwC point of view

To ensure proper oversight, firms may want to consider implementing formal assessments of pricing service providers at least annually, using consistent criteria and metrics to rate the vendors. It is good practice to retain documentation of these reviews, to support conclusions made and actions taken.

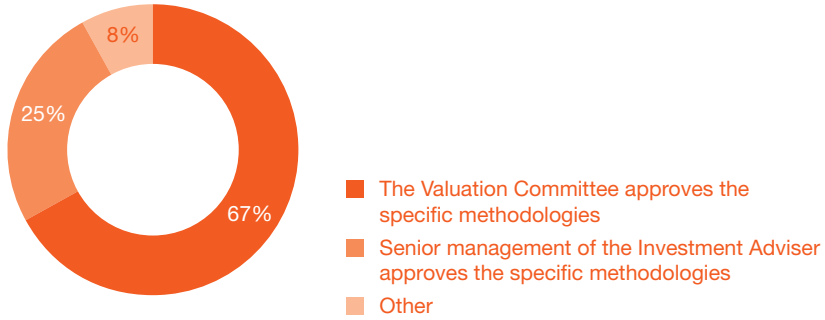
Observations

Forty-two percent of respondents noted that their boards do not perform or review assessments of vendor pricing services. It is important for firms to be aware that the SEC requires boards to have some level of involvement; therefore, firms might consider putting processes in place to ensure that there is at least high-level board oversight. Twenty-five percent of respondents perform assessments on an annual basis, which is the minimum threshold for these reviews.

As reflected in the "Other" category, some respondents noted that pricing services were reviewed as needed, with a minimum of quarterly. A small number indicated that the services were reviewed daily, or that the board is apprised of which vendors are used, and of each vendor's strengths and weaknesses.

Approval of valuation methodology

Who approves the specific methodologies for how security types should be valued?



PwC point of view

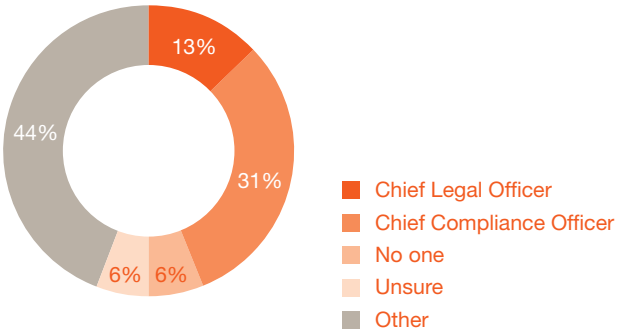
Alternative asset managers may want to consider giving the board of directors or its equivalent responsibility for approving a high-level framework for accounting and valuation. Significant changes to accounting and valuation methodologies should be reported to the board of directors. Responsibility for the design of detailed accounting/valuation methodologies may be given to a senior management group reporting to the CFO or equivalent.

Observations

All respondents stated that the valuation committee, senior management, or both review specific valuation methodologies, which is in line with our point of view.

Oversight of the disclosure process

Who monitors compliance with disclosures made to the Board and investors?



PwC point of view

It is important for alternative funds to understand that under Rule 38 a-1 of the Investment Company Act of 1940, a registered fund's CCO is responsible for monitoring the effectiveness of its compliance policies and procedures as well as monitoring compliance of the fund's service providers. Such monitoring includes periodic testing of the procedures to determine whether they were designed adequately and are operating effectively. While Rule 38 a-1 does not apply to alternative funds, consideration should be given to having the adviser CCO play a role in monitoring all compliance policies and procedures including the adequacy of disclosures.

Observations

Almost one-third (31%) of respondents identified the CCO as being responsible for monitoring compliance with disclosures made to the board and investors. While CCOs are not expected to be valuation experts, they are expected to address the fair valuation process as part of their testing and reporting responsibilities. As a result, the CCO may want to consider whether the organization consistently makes public disclosures concerning fair valuation and whether it has a process for timely board reporting and review of fair value matters.

At least 12% of respondents noted that no one is responsible for reviewing disclosures, or they are unsure who has that responsibility. With the impending legislation that will require registration of alternative fund managers, firms will need to consider more stringent processes to cover disclosures.

Respondents who chose "Other" noted that a committee, the Chief Financial Officer, Chief Accounting Officer, Chief Operating Officer, general counsel, or the director of valuations reviews the disclosures.

Review of financial statement disclosures

Does the Board/Goverance Committee or a committee-approved designee other than fund administration review the financial statement disclosures relative to the valuation process, e.g., ASC 820 levels, description of inputs and processes?

PwC point of view

The board should consider leveraging the CCO, management, the adviser, and service providers to assist with oversight responsibilities. This effort may include obtaining regular updates in such areas as regulatory compliance, financial reporting, accounting, and legal matters.

Observations

Regardless of whether the board designates management to review financial statement disclosures, it is important that the board or its equivalent obtain regular updates. According to our survey, many boards are not receiving such updates. Thirty-eight percent of respondents noted there is no review by, or reporting to, the board with regard to disclosures. The board has responsibility to maintain oversight over disclosures, and alternative funds may want to revisit their reporting practices as they prepare to register with the SEC.

Sixty-nine percent of respondents say their organizations rely on management to review financial statement disclosures relative to the valuation process. This is appropriate as long as there is proper oversight from the board.

Conclusion

Like their traditional fund counterparts, alternative asset managers are faced with the risk of market volatility and changing liquidity as well as concerns over the reliability of data provided by pricing sources. Almost all of the firms we surveyed (94%) have a valuation committee in place to manage and oversee valuation policies and procedures. This is encouraging, given many of the alternative firms surveyed are not currently registered.

That said, there is a lack of consistency in the materials that alternative asset managers are providing to their valuation committees, and almost one-third of respondents are not providing valuation information to the boards of their offshore corporations. This suggests that these boards may not have the same level of transparency to valuation documentation and conclusions when compared to other asset management sectors. This may change in the coming year as registration of firms commences. The survey responses highlight aspects of the valuation process that alternative asset managers may want to focus on, particularly those firms that are preparing for registration with the SEC.

Private equity and venture capital firms

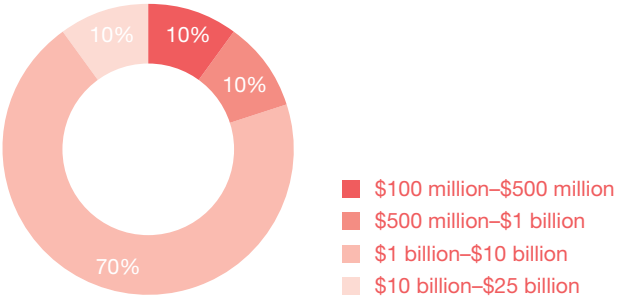
Survey results by sector

Introduction

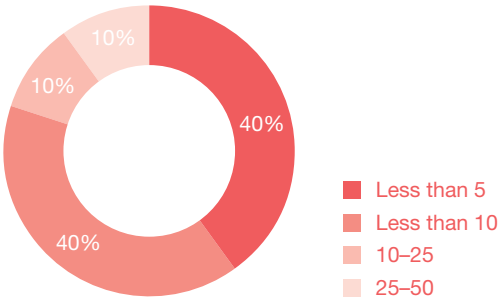
PwC surveyed private equity and venture capital firms that manage from $100 million to $25 billion in assets. On the following pages we provide an overview of the survey findings, details of participants' responses to each of the questions we posed, on topics ranging from the key valuation risks to the review of financial statement disclosures, and our point of view on each topic.

Participant information

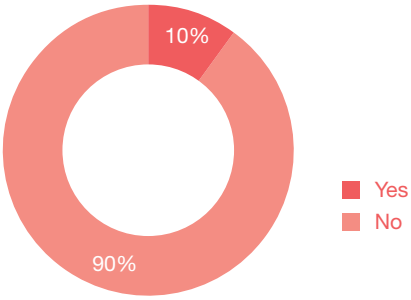
What are the assets under management (both registered and non-registered)?



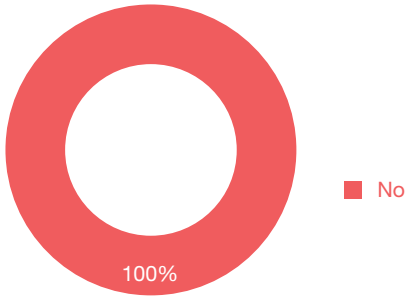
What is the number of funds under management (both registered and non-registered)?



Is the Adviser registered with the SEC?



Has the fund complex been subject to a sweep examination by the SEC on valuation in the last 12 months?



Overview of roles and survey findings

The following is an overview of the role of management, the valuation committee, and the board (or its equivalent) of private equity and venture capital funds, as well as their oversight of valuation disclosure activities. Responses to individual survey questions, and PwC's perspective on those responses, follow (see "Survey results").

The role of management

In all asset management firms, management is responsible for the day-to-day operations of the funds it oversees, including the selection and oversight of key service providers, regardless of the funds' legal structure or regulatory oversight. Management is also responsible for managing the pricing and valuation process for fund securities. This process involves identifying the valuation risks implicit in each fund's investment strategy and creating a series of controls to seek to mitigate and manage those risks. This has become much more difficult with increasing complexity in investment strategies and uncertain volatility in the market. These challenges are amplified with the reduction of valuation inputs that are observable for certain asset classes and the limited transparency of information received from third parties.

For the private equity/venture capital sector, the use of models and identification of inputs such as market comparables is the most consistently identified risk that must be managed; this risk was cited by 60% of respondents. Although market volatility and changing liquidity was not cited by most respondents as a key risk they must manage, it is noteworthy that 40% of managers still identified it as a valuation risk in their organizations.

Compared to traditional and alternative funds, chief financial officers (CFOs) in this sector play a more significant role in the valuation process; 40% of respondents identified the CFO as being ultimately responsible for the valuation process. Of the remaining respondents, 30% have a valuation committee or its equivalent in place and this group, not the CFO, is ultimately responsible for valuing assets.

Like alternative and traditional fund managers, private equity/venture capital asset managers surveyed gave their internal pricing groups a strong vote of confidence, in terms of the quality and quantity of the groups' internal resources. This is not surprising, given that firms in this sector have a long-established practice of valuing their investments internally, and have largely put in place the resources to do so. As a result, 70% of respondents said they do not use external valuation experts to value their portfolios. Those that use external valuation experts do so to value assets outside their normal areas of expertise, such as options or goodwill.

The role of the valuation committee

Sixty percent of respondents indicated their firms have a valuation committee, and another 10% are considering implementing such a governance structure. We view the trend of having a valuation committee in place for this sector as an important aspect of the control environment, and one that regulators will emphasize.

Perhaps because of the nature of their assets, deal teams and analysts play a much more significant role in the valuation process in this sector than in traditional or alternative asset management firms. Of particular note, 60% of respondents indicated that the CFO (or equivalent) is a member of the valuation committee, reinforcing the conclusion that finance personnel in private equity/venture capital organizations are often responsible for the valuation process.

All survey participants indicated that their private equity/venture capital valuation committees meet quarterly. The information provided to these committees is more consistent than the material provided to the valuation committees of alternative asset managers. Most committees (60%) are provided a summary of the valuation methodology, and about half receive what is deemed by respondents to be "sufficient portfolio company information".

The role of the board or its equivalent

In carrying out their responsibilities, boards or its equivalent have generally looked to the valuation committees and the compliance function to help execute their duties. The Securities and Exchange Commission (SEC) has stated that while boards can delegate day-to-day valuation responsibility to others, they still retain ultimate accountability.

Thirty percent of respondents identified no oversight process beyond the valuation committee, while the remaining 70% were split between boards, risk committees, limited partner advisery committees (LPACs), and direct oversight from the partners of the general partnership. Where an oversight function is in place, firms provide essentially the same information to both the valuation committee and oversight groups.

Unlike alternative or traditional funds, many asset managers in this sector have investor input into their valuation process. This is achieved through the LPAC. Ninety percent of respondents identified the existence of such a committee; of these, 67% have the committee review their valuation practices and policies.

Oversight of the disclosure process

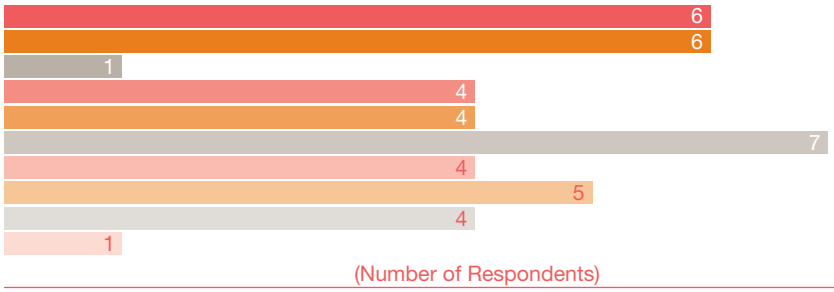
Since 90% of the firms in this sector that participated in our survey are not registered with the SEC, they had no regulatory requirement to have a chief compliance officer (CCO) in place at the time of the survey. As a result, 70% of respondents indicated that the CFO is responsible for ensuring compliance with disclosures made to the board and investors. Private equity respondents will need to consider whether, in the new regulatory environment, it is appropriate for the newly designated CCO to have a larger role in the review process.

Sixty percent of all respondents in this sector noted that the review of financial statements was left to management, and that no reporting is provided to any oversight committee, such as a board or its equivalent.

Survey results

Key valuation risks

Which of the following are key valuation risks specific to your organization? Select all that apply.



- Timely identification of significant portfolio company events in performing reliable and timely valuations
- Use of internally developed models to value positions
- Valuation based on co-investor valuations
- Valuations based only on varying rounds of financing
- Impact of debt at the portfolio company on the valuations
- Selecting and obtaining appropriate market comparables
- Reliability of information obtained from portfolio companies
- Use of internal information provided by deal team to estimate fair values
- Market volatility and changing liquidity
- Other

PwC point of view

A sound valuation process begins with a robust definition of the key valuation risks that senior management and the board or its equivalent agree they need to monitor and mitigate. Once the risks are identified, management can develop controls that monitor and mitigate the risks, and management can provide reports to those charged with governance.

We believe that the valuation risks highlighted in the chart above represent key risks for most organizations, and if not appropriately monitored and controlled, significantly increase the potential for error in valuing portfolios.

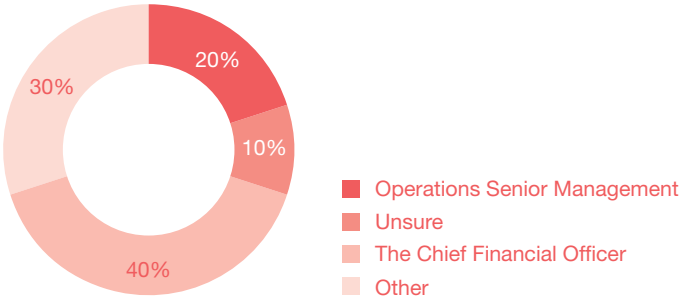
Observations

Topping the list of valuation risks for private equity/venture capital firms is selecting and obtaining appropriate market comparables, cited by 70% of respondents. Two other risks, each were cited by 60% of respondents: the timely identification of significant events, and the use of internally developed models to value positions. Surprisingly, these three risks were not identified as risks by all respondents, and less than half of respondents view the remaining risks listed above as significant. Because these three risks are the most significant ones for this sector, management may want to hold sessions to identify and mitigate potential recurring risks in these areas. In addition, firms might consider developing plans to address risks that could occur unexpectedly, such as a significant event.

As with other risk management operations, there is no foolproof method to eliminate valuation risks, but the risks can be minimized through the vigilance and oversight of senior management and boards. In an effective organization, these stakeholders never lose sight of the ultimate goal: valuations that treat all stakeholders fairly.

Responsibility for the valuation process

Who in management is ultimately responsible for the valuation process?



PwC point of view

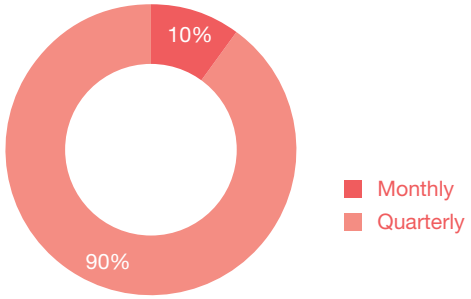
Consideration should be given to assigning a senior management group responsibility for managing and overseeing control and valuation policies and procedures. This group would report the results of its work directly to those charged with governance over the funds. Members may include representatives from market risk management, credit risk management, financial control/ product control groups, senior business management, tax, and legal. This group would prepare and review documentation and, where relevant, the board of directors or equivalent would be involved in approving the fair values.

Observations

Twenty percent of respondents identified senior management as the group responsible for the valuation process, while 40% indicated the CFO is responsible, and 30% said the responsibility falls on one of several groups, such as the valuation committee, investment committee, or LPAC. The benefit of a committee approach is that it represents a degree of independence and objectivity through representation by several key stakeholders in the organization. It is difficult to achieve this independence when the CFO alone is ultimately responsible for the valuation process.

Frequency of portfolio value reviews

How frequently is management valuing the portfolio?



PwC point of view

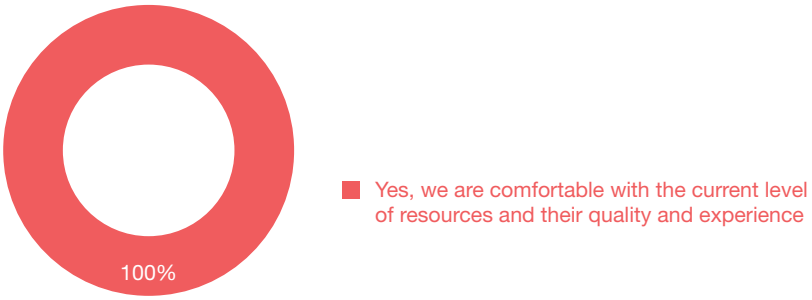
Firms with effective governance undertake a rigorous and regular process to determine fair values, with the results reported to senior management. Where fair value is a critical component of reported results (which is typical in private equity/venture capital funds), firms should consider having senior management report the price verification results to the committee charged with governance over the funds.

Observations

Ninety percent of respondents indicated that portfolio values are reviewed on a quarterly basis. This is consistent with industry trends. However, management might consider undertaking price verification outside the normal reporting cycle, particularly if there are significant events or transactions that result in the identification of a potential challenge. It is important that input into the price verification process be completed by individuals who are independent of the transaction execution.

Resources performing valuation

Do you believe the group performing the valuation procedures has the appropriate level of resources, skills, and experience?



PwC point of view

Consideration should be given to assigning an appropriately qualified and experienced independent price verification (IPV) group responsibility for determining the fair values of assets. Where fair value is a critical component of reported results, IPV groups would access dedicated quantitative professionals within financial controls or risk management to deal with complex price verification issues. A key component of the IPV group's work is to verify the pricing model, independent of risk-taking activities, using highly experienced and qualified quantitative professionals. Members of the IPV group typically includes appropriately experienced (e.g., product controllers, risk managers, valuation experts, and qualified accountants) with significant on-the-job experience as well as specialist training.

Observations

Although 100% of respondents are comfortable that they have valuation resources in place with the "appropriate" level of skill and experience, management may want to reassess resource needs frequently. Portfolios are becoming more complex and over time could require new valuation skills.

Frequency of using external valuation experts

Does the firm use external valuation experts?

PwC point of view

Some respondents indicated they are turning to valuation experts for valuations of complex or unusual instruments, with many large funds receiving independent valuations for a fee.

Firms may want to consider performing formal assessments periodically, using consistent criteria and metrics to rate these external experts. Periodic reviews could include an assessment of the expert's experience with new asset classes, their valuation process, and their valuation methodology. It is good practice to retain documentation of these reviews, to support conclusions made and actions taken. It is also a good practice to correspond with others in the industry to assist in evaluating the quality of the experts' past valuations.

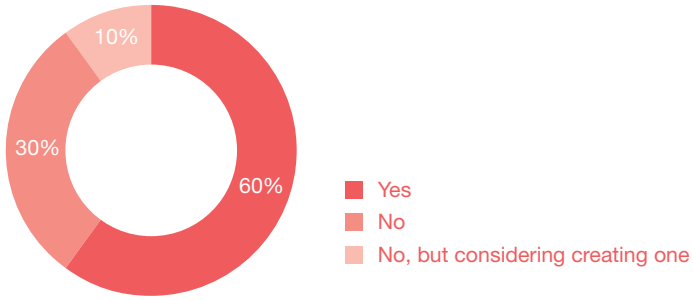
Observations

Seventy percent of respondents do not use external valuation experts. This is not an uncommon or unexpected finding because many private equity firms have the viewpoint of having the requisite resources internally to perform the valuations.

Overall, it appears that management is comfortable with both their internal and external resources when it comes to performing valuations. The environment is however constantly changing and investor demands, or those of the regulators, may influence approaches to this area in the private equity/venture capital sector. Firm's should stay close to trends in this area as they develop over time.

The valuation committee

Do you have a committee specifically responsible for the management and oversight of the valuation policies and procedures, e.g., Valuation Committee?



PwC point of view

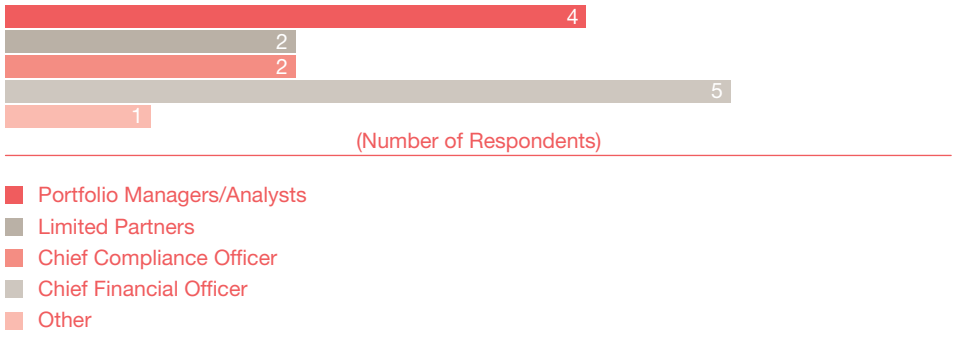
Firms should consider assigning a senior management group responsibility for the management and oversight of control and valuation policies and procedures. This group would report the results of its work directly to those charged with governance of the funds. Members may include representatives from market risk management, credit risk management, financial control/product control groups, senior business management, tax, and legal. Senior management would prepare and review the appropriate documentation and, where relevant, the board of directors or equivalent for all processes might be involved in the approval of fair values.

Observations

Seventy percent of respondents have a valuation committee in place or are considering establishing one. As the data suggests, valuation committees are becoming more commonplace. Because many private equity (nor venture capital) firms will now be required to register with the SEC as investment advisers, management will have to demonstrate it has developed and implemented reasonable and effective valuation procedures, and that these procedures are being applied fairly and consistently. The presence of a committee that is independent and free of conflicts of interest could assist in demonstrating to the regulators and the firm's investors that they are complying with these requirements.

Composition of the valuation committee

What is the composition of the Valuation Committee? Select all that apply.



PwC point of view

Management's valuation committee normally consists of senior management who resolve valuation questions and exercise oversight responsibilities covering the external experts, administrators, and fund personnel involved in the valuation process. To reduce the potential for management bias, it is desirable for voting members of the valuation committee to be independent of the portfolio management function. Independence, accountability, and segregation of duties are important organizational concepts that effective boards and managers embrace.

Certainly, the deal team and other investment professionals can provide important input to the committee, but ideally they will not serve in a decision-making role. In our experience, the CCO or chief risk officer (CRO) in many registered advisers does not serve in a decision-making capacity. It is more common for the officer to attend valuation committee meetings only to observe and ensure that the process is performed in accordance with approved valuation policies and procedures. It is often more appropriate to separate CCOs from valuation-related operational roles so that they have no conflict of interest in reporting on compliance processes in which they actively participated.

It is important that any valuation committee member bring objectivity and good judgment to the deliberations and recognize that the charge is to be fair to all stakeholders, not to always seek the highest valuations (or, equally, to be automatically conservative).

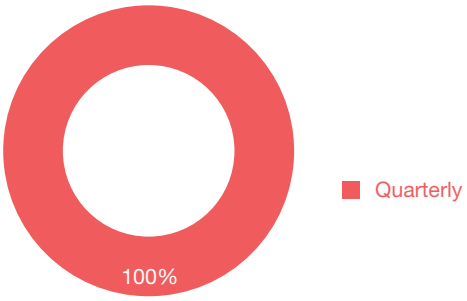
Observations

Fifty percent of respondents have finance staff on their valuation committees, 40% have investment professionals, and only 20% indicate that the CCO is on the committee. Given that only 10% of private equity respondents are registered with the SEC, many of these organizations are unlikely to have a designated CCO, and as such, the small representation by the CCO is expected in the current environment. In the "Other" category, respondents indicated that the chief executive officer, chief administrative officer, and chief operating officer are part of the valuation committee.

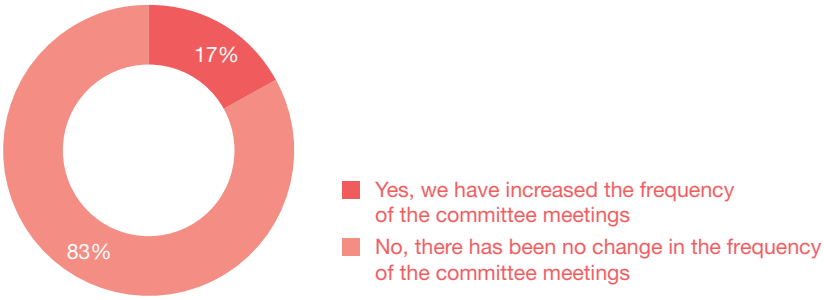
As firms register as investment advisers, they will need to reconsider the composition of these committees. As noted above, independence and segregation of duties are important organizational concepts, and the SEC will be looking to see that these concepts are an integral part of management's control structure. Based on the responses received, advisers might consider whether the current composition of the committees is adequate. On the positive side, 20% of respondents listed the limited partners as members of the committee, thus reducing to some extent the potential for management bias in the decision-making process.

Frequency of valuation committee meetings

How often does the Valuation Committee meet?



Has the frequency of the committee meetings changed as a result of the recent market activity/volatility?



PwC point of view

How often a committee meets is not as important as ensuring that the group meets as often as is appropriate. For example, when markets become more volatile, as we have seen in the past two years, and fair valuations increasingly replace prices based on market transactions, this committee may need to meet more often to determine how to provide the necessary oversight.

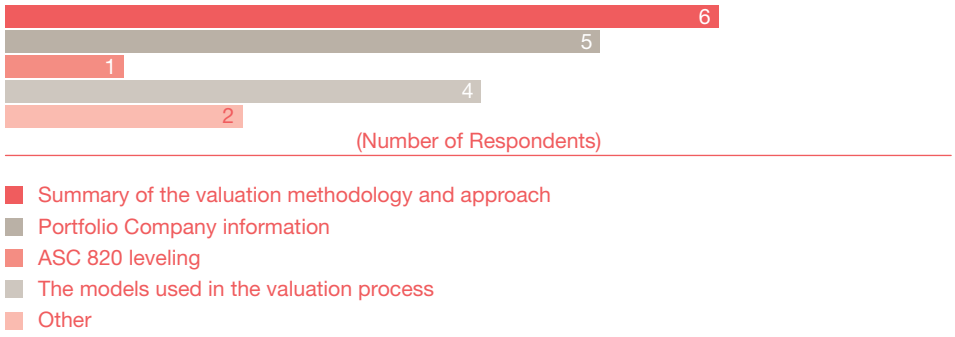
Observations

Valuation committees meet consistently every quarter, according to those surveyed. When firms assess the timing of meetings, they might consider the state of the market and of their portfolios. For example, if the market shows significant dislocation and meeting frequency has not increased even temporarily, firms will have to assess whether they are meeting often enough to properly manage the increased risk in the portfolio values.

Eighty-three percent of respondents noted that market volatility has had no impact on their process. Given the nature of most private investments, this is expected. However, respondents may want to evaluate whether the use of market comparables, and the impact that volatility will have on those comparables, may necessitate a re-evaluation of that conclusion. Thereafter, in assessing whether they are meeting either too much or too little in comparison to their peers, respondents may have to consider the state of the broader public market and its impact on their portfolios.

Analyses/documentation reviewed by valuation committee

What analyses/documentation are reviewed by the committee? Select all that apply.



PwC point of view

As noted in the executive summary, there continues to be inconsistency in what analyses are provided to the valuation committee. As a starting point, management may consider including information about the following controls and processes in reports provided to the valuation committee:

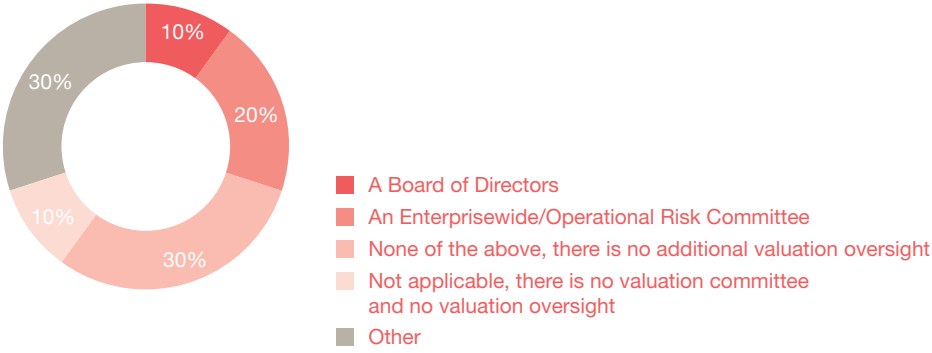
- An independent review of manual inputs
- A control to select appropriate market comparables
- A report to compare portfolio sales or subsequent market events such as IPOs to previous valuations
- A control to assess the validity of data received from portfolio companies
- A control to assess the relevance of models and methodologies used across the organization
- A control to review external experts, if used.

Observations

As noted earlier, the three forms of analyses and documentation cited most frequently by respondents include the valuation methodology and approach, portfolio company data, and modeling. The majority of respondents provide reporting to their valuation committee—a positive finding. Other types of analyses and documentation reported include changes in valuation from quarter to quarter, comparable reports, and public and private third-party analysis.

Oversight of the valuation process

Apart from the Valuation Committee, which of the following has any oversight of the valuation process? Select all that apply.



PwC point of view

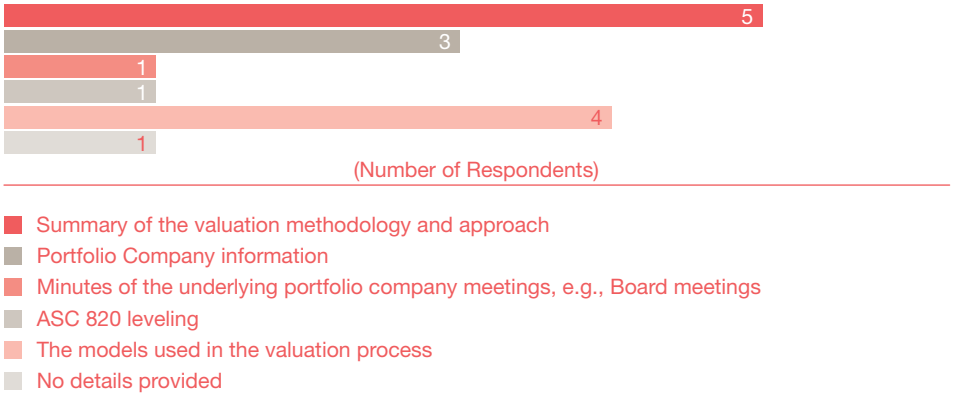
With respect to oversight of the valuation process, the SEC has indicated that the board of directors of funds is responsible for establishing a fund's valuation policy, and that the commission expects directors or their equivalent to exercise independent, objective oversight and judgment in the execution of the policy and related valuation and pricing procedures. Because the SEC places a clear responsibility on fund directors for valuation, this governance responsibility normally resides with the board or a valuation committee of the board. This board committee would establish the valuation policies and procedures to be executed by fund managers and pricing services and normally would review valuation results on a timely basis.

Observations

Forty percent of firms have no enterprise or operational committee to oversee the valuation of investments. A small number of respondents noted that all partners in the firm are involved in valuation reviews, and others indicated that the LPAC is involved in the process. To provide reasonable assurance that there is some form of objective, independent oversight, firms may want to consider some of the other control mechanisms that were identified in the survey, such as the LPAC and general partner overview committees.

Documentation and analyses provided to oversight groups

What valuation analyses/documentation is provided to this oversight group? Select all that apply.



PwC point of view

As a starting point, the following information is important to provide to the valuation governance committee:

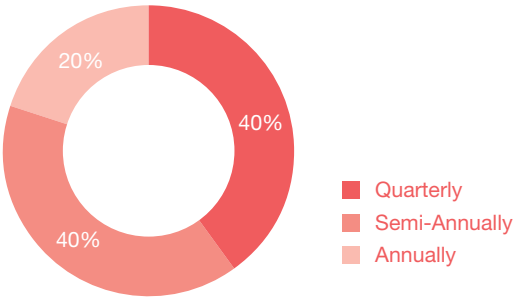
- External fair value disclosures that adequately describe risks and other salient factors
- Clear documentation summarizing the investment, valuation approach applied, and key assumptions

Observations

According to the survey respondents that have valuation committees, the information provided to oversight and valuation committees is largely consistent. Management may want to periodically review new analyses or reports provided to the valuation committee and consider whether it would be appropriate to provide similar reports to any additional oversight committees.

Frequency of providing valuation analyses to oversight groups

How frequently are these valuation analyses provided to this oversight group?



PwC point of view

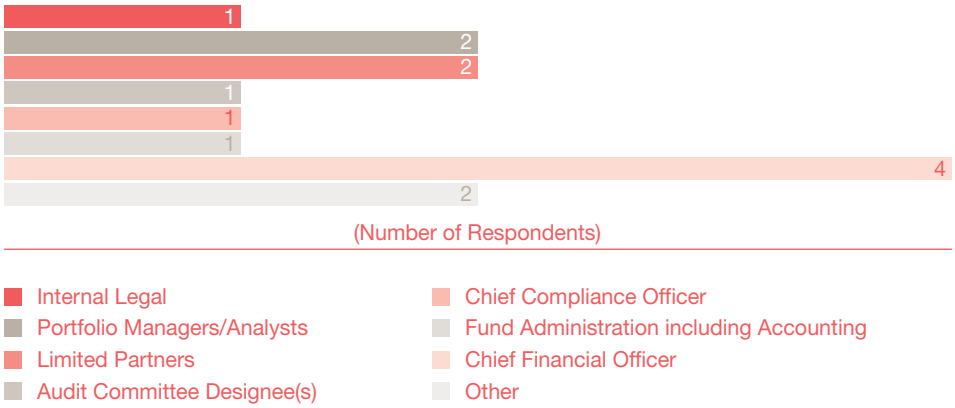
Valuation policies and procedures and related analyses performed at least annually can help to ensure proper oversight of the valuation process.

Observations

How often valuation analyses are provided to oversight groups depends on the structure of the organization and types of investments as well as the volatility of the market. Eighty percent of respondents provide analyses at least twice a year, as we would expect in such a volatile market. This positive business practice helps to mitigate risks in the valuation process.

Composition of oversight groups

What is the composition of this oversight group? Select all that apply.



PwC point of view

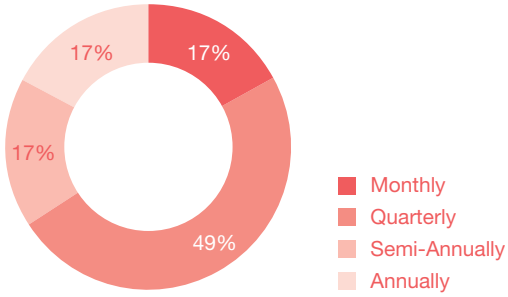
Oversight committees should consist of senior management with responsibility to resolve valuation questions and exercise oversight responsibilities covering the valuation committee, administrators, and fund personnel involved in the valuation process.

Observations

There was little consistency among respondents concerning the composition of their oversight committees. Furthermore, the survey results indicate that companies would be well served to evaluate the composition of these groups to ensure they are appropriately independent. Some committee members cited by respondents—for example,—portfolio personnel—may not represent the appropriate level of independence. Organizations with these members in their oversight group may want to re-evaluate whether the appropriate level of independence exists. If deal team personnel remain part of the process, management might consider making them non-voting members.

Frequency of oversight group meetings

How often does this oversight group meet?



PwC point of view

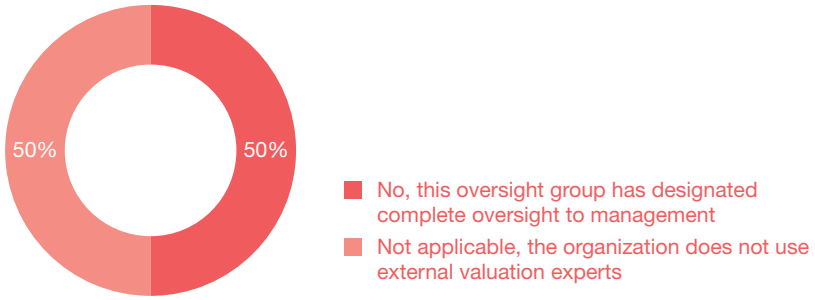
How often a committee meets is not as important as ensuring it meets as often as is appropriate. For example, when markets become more volatile, as we have seen in the last two years, and fair valuations represent the majority of the portfolios in private equity and venture funds, this committee may need to meet more frequently to determine how to provide the necessary oversight.

Observations

Survey results indicate diversity in the frequency of oversight group meetings. In assessing whether they are meeting either too often or too infrequently relative to their peers, respondents might consider the state of the market and of their portfolios. For example, if the market shows significant dislocation and the group is not meeting more frequently, even temporarily, firms may want to assess whether they are meeting often enough to properly manage the increased risk in the portfolio values.

Oversight groups' monitoring of external experts

Does this oversight group or their approved designees have independent and direct oversight of the external valuation experts hired for the funds?



PwC point of view

The day-to-day responsibility for monitoring external valuation services should rest with a fund's management. However, because fund directors hold a clear responsibility for valuation, this governance responsibility normally resides with the board or a valuation committee of the board.

Observations

All of the respondents that use external valuation experts noted that the board has delegated complete oversight of these experts to management. Firms that use external valuation experts will still want to ensure that the oversight group is kept informed of the results of management's oversight process, as regulators expect that the oversight group retains ultimate responsibility. Accordingly, with the use of experts in a firm's valuation process, it requires management to consider other control practices relating to the oversight of the experts. Firms may want to consider performing formal assessments periodically, using consistent criteria and metrics to rate these external experts. Periodic reviews could include an assessment of an expert's experience with new asset classes, their valuation process, and their valuation methodology. It is good practice to retain documentation of these reviews, to support conclusions made and actions taken. It is also a good practice to correspond with others in the industry to assist in evaluating the quality of the experts' past valuations.

Approval of valuation methodology

Who ultimately approves the specific policies and methodologies for how portfolio companies should be valued?

PwC point of view

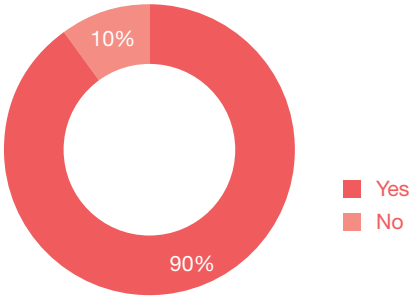
Firms should consider assigning responsibility to the board of directors or its equivalent to approve a high-level framework for accounting and valuation. Significant changes to accounting and valuation should be reported to those charged with governance. Responsibility for the design of detailed accounting/valuation methodologies may be given to a senior management group.

Observations

There is variation in those private equity/venture capital firms surveyed in terms of who approves valuation policies. As discussed in the executive summary, it is important that whoever is responsible be independent of the process and execute their fiduciary responsibility on behalf of investors.

Limited partner advisory committees

Is there a Limited Partner Advisory Committee in place?



PwC point of view

The LPAC is usually comprised of seven or eight voting representatives of limited partners; larger funds may have as many as 12 members.[1] Regardless of the size of the LPAC, it is important that its members represent a diverse group of investors. Firms should consider making a reasonable number of non-voting observer seats available to certain limited partners.

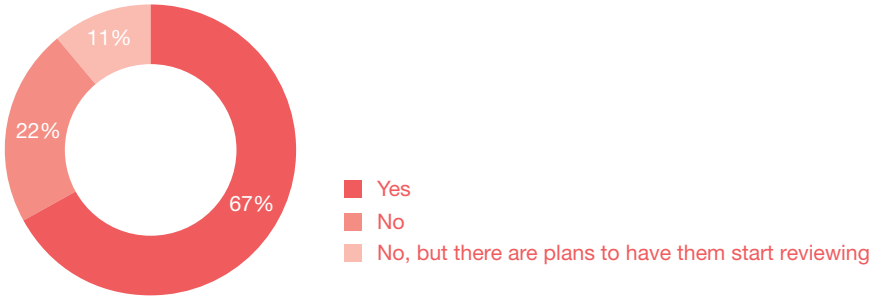
By adopting and standardizing LPAC meeting processes and procedures, firms can allow this sub-body of the limited partners to effectively execute its role.

Observations

Ninety percent of firms in this sector use an LPAC. The presence of an LPAC suggests there is someone who is independent of the day-to-day valuations process, and is available to contribute to the governance process with the best interests of investors in mind.

1. Source: Institutional Limited Partners Association: Private Equity Principals

Are valuation practices and policies reviewed with the Limited Partner Advisory Committee?



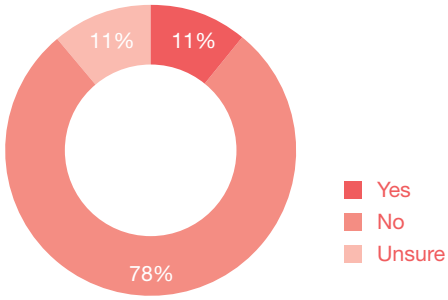
PwC point of view

The general partner should consider documenting valuation policies and practices and reviewing them with the LPAC. Changes in policy, practice, or application would also be discussed with the LPAC. It is good practice to review the valuation of portfolio companies with the LPAC quarterly, at a minimum.

Observations

Sixty-seven percent of respondents noted that their LPACs review valuation policies. As noted above, the presence of an LPAC suggests there is someone not affiliated with the organization who is acting in the best interest of investors.

Does the Limited Partner Advisory Committee discuss valuations with the independent auditors?



PwC point of view

Although it is not considered necessary for the LPAC to have access to fund auditors to discuss valuations, it is a good idea to have a representative of the audit firm be available to attend each year-end LPAC meeting upon request.[1]

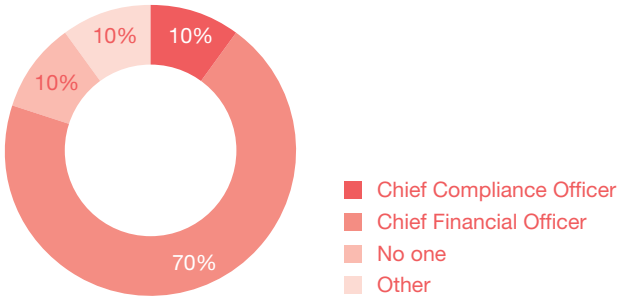
Observations

It has not been an industry norm for LPACs to meet with auditors, and the survey results confirm this; only 11% of respondents indicated they had met with auditors. While such meetings are not standard practice, they could help LPACs to gain broad industry perspectives on valuation issues.

1. Source: Institutional Limited Partners Association: Private Equity Principals

Monitoring compliance of disclosures

Who monitors compliance with disclosures made to the Oversight Committee and investors?



PwC point of view

A fund's CCO is responsible for monitoring the effectiveness of its compliance policies and procedures as well as monitoring compliance of the fund's service providers. Such monitoring includes periodic testing of the procedures to determine whether they were designed adequately and are operating effectively.

Observations

Only 10% of respondents identified the CCO as being responsible for monitoring the effectiveness of compliance policies and procedures. This result is not unexpected, given that only 10% of respondents in this sector are registered and thus required to presently have a designated CCO.

In the new regulatory environment most, if not all, of the private equity firms that participated in our survey will be required to register and designate a CCO. As many may be aware, venture capital firms are exempt from registration under the Dodd-Frank Act. For private equity respondents that are newly registered, it is important to note that while CCOs are not expected to be valuation experts, they are expected to address the fair valuation process as part of their testing and reporting responsibilities. As a result, CCOs may want to consider whether disclosures concerning fair valuation are consistent within the organization, and whether a process is in place for timely board reporting and review of fair value matters.

At least 10% of respondents indicated that no one in their organization is responsible for reviewing compliance with disclosures. With the newly passed legislation that will require registration, firms may need to revisit this area given regulator's expectations.

Who reviews financial statement disclosures?

Does the Oversight Committee or a committee-approved designee (other than fund administration) review the financial statement disclosures relative to the valuation process, e.g., ASC 820 levels, description of inputs and processes?

PwC point of view

The oversight committee should consider leveraging the CCO, management, the adviser, and service providers to assist with oversight responsibilities. This effort may include obtaining regular updates in such areas as regulatory compliance, financial reporting, accounting, and legal matters.

Observations

Twenty percent of respondents indicated that management reviews financial statement disclosures relative to the valuation process. This is appropriate, as long as there is proper oversight.

Sixty percent of respondents noted that in their organizations, there is no review by, or reporting to, the oversight committee in regard to disclosures. Regardless of whether management is given responsibility for reviewing financial statement disclosures, it is important that the oversight committee obtain regular updates on such matters.

Conclusion

Private equity/venture capital funds are concerned about three key valuation risks, related to selecting and obtaining appropriate market comparables, timely identification of significant events, and the use of internally developed models to value positions. While 60% of respondents said they have a valuation committee in place to manage and oversee valuation policies and procedures, almost a third indicated that their organizations have no oversight process beyond this committee. With the changing regulatory landscape, some firms may want to reconsider the makeup of their committees as they prepare to register as investment advisers, in order to meet expectations of the regulators for independence and objectivity. These many challenges in response to the Dodd-Frank Act that private equity firms face are similar other sectors such as alternative and real estate firms and will require significant management attention and dedicated resources in the coming years.

Real estate asset managers

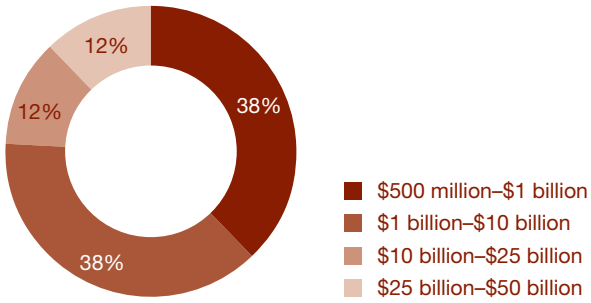
Survey results by sector

Introduction

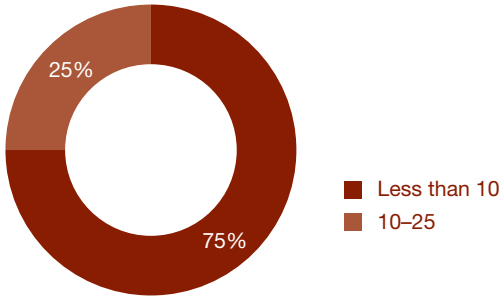
PwC surveyed real estate firms that manage from $500 million to $50 billion in assets. On the following pages we provide an overview of the survey findings, details of participants' responses to each of the questions we posed, on topics ranging from the key valuation risks to the review and approval of valuation service providers, and our point of view on each topic.

Participant statistics

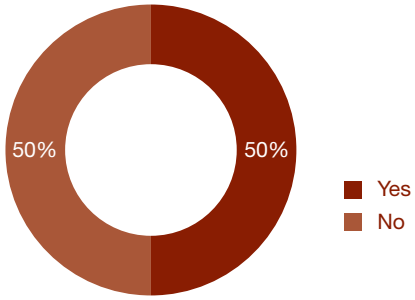
What are the assets under management (both registered and non-registered)?



What is the number of funds under management (both registered and non-registered)?



Is the Adviser registered with the SEC?



Overview of roles and survey findings

The following is an overview of the role of management, the valuation committee, and the board (or its equivalent) of real estate asset managers, as well as their oversight of valuation disclosure activities. Responses to individual survey questions, and PwC's perspective on those responses, follow (see "Survey results").

The role of management

In all asset management firms, management is responsible for the day-to-day operations of the funds it oversees, including the selection and oversight of key service providers, regardless of the funds' legal structure or regulatory oversight. Management is responsible for the valuation of real estate investments. This process involves identifying the valuation risks implicit in each fund's investment strategy and creating a series of controls to seek to mitigate and manage these risks. Such mitigation has become much more difficult with increasing complexity in investment strategies and market volatility. These challenges are amplified with the reduction of valuation inputs that are observable for real estate.

In recent history, real estate asset managers have experienced increasing difficulty valuing their investments because of a decline in the volume and level of market activity and the resulting lack of relevant market information. It is not surprising, then, that 75% of survey respondents identified market volatility and changing liquidity as the key valuation risks their organizations must manage. The second most commonly cited risk, identified by 62% of respondents, is the use of internal information provided by the deal team to estimate fair values. It is noteworthy that less than half of respondents named the timely identification of significant events in performing reliable and timely valuations as a key valuation risk for their organization, especially with the negative impacts on the economy, debt and real estate markets during the past two years.

Seventy-five percent of respondents indicated that senior management or a fund administrator is responsible for reviewing and approving specific valuation policies and methodologies. The quality and/or adequacy of resources was not viewed as a significant concern, with all respondents indicating that the group performing valuation procedures has the appropriate level of resources, skills, and experience. This is consistent with the responses of asset managers in the alternative, traditional, and private equity sectors. However, perhaps as a result of the shortage of available market data and increasing complexities of real estate investments, 88% of respondents indicated that their respective organizations use external valuation experts as an independent resource to establish valuations.

The role of the valuation committee

Although a fund's board of directors or its equivalent bears ultimate responsibility for setting policies related to the valuation of portfolio investments, boards delegate the day-to-day valuation responsibility to management of the investment adviser and a committee, usually a valuation committee. As noted earlier in the executive summary, the valuation committee or its equivalent is becoming the norm in all sectors. Real estate is no exception.

Eighty-eight percent of survey respondents have a valuation committee, or its equivalent, that is responsible for reviewing and approving specific valuation policies and methodologies. Asset management (88%) and acquisitions/underwriting professionals (63%) are the most represented disciplines on valuation committees. Organizations also have staffed their valuation committees with resources across other business functions, including accounting (50% of respondents), finance (38%), and compliance/legal (13%).

Of the respondents whose organizations have valuation committees, 86% indicated the committees meet quarterly, while the remaining 14% answered "ad hoc or as needed." Forty-three percent of respondents noted that the frequency of committee meetings has increased as a result of recent market activity/volatility.

The nature and content of information provided to real estate valuation committees is generally consistent, according to survey results. Such information includes key valuation assumptions by investment (cited by all respondents), detailed cost and value information by investment (86%), and summaries of investment performance (86%). Based on survey results, it appears that few committees (only 14%) are provided with ASC 820 disclosures.

The role of the board or its equivalent

In carrying out their responsibilities, boards have generally looked to valuation committees and the compliance function in their organizations to help execute these responsibilities. The Securities and Exchange Commission (SEC) staff has stated that while boards can delegate day-to-day responsibility for valuation to others, boards still retain ultimate accountability.

Half of the respondents have an advisory committee or other governance body exclusive of management to review real estate asset valuations and valuation policies and procedures. The frequency of these reviews varies, with an equal number of respondents indicating that reviews are completed monthly, quarterly, annually, or "other".

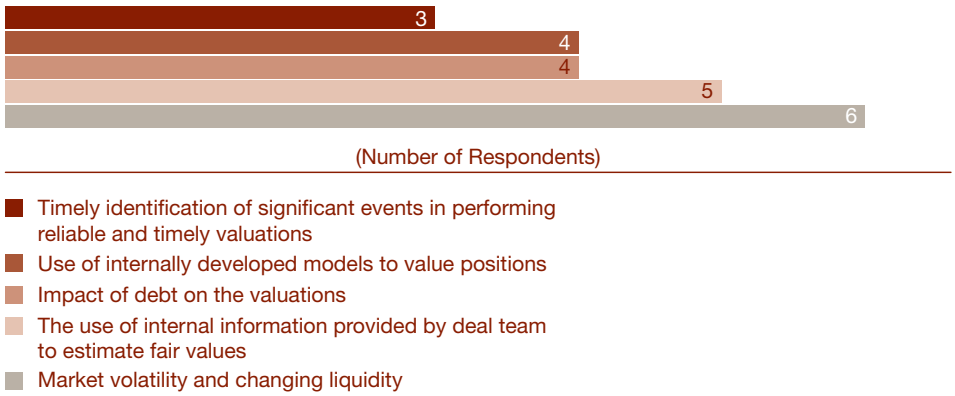
Oversight of the disclosure process and C-suite structure

There appears to be less oversight of the disclosure process at real estate organizations than within traditional, alternative, and private equity/venture capital firms. Reinforcing the findings that suggest there is little oversight of the disclosure process within real estate organizations, only 14% of respondents provide their committees with ASC 820 disclosures. Further, with respect to the current C-suite structure, only 25% of real estate respondents indicated that their organizations have both a chief compliance officer (CCO) and chief risk officer (CRO). Half stated that there is neither a CCO nor a CRO, and the remaining 25% indicated that only a CCO function exists in their organization. With the Dodd-Frank Act, many organizations may be revisiting their C-suite composition given the increased regulatory requirements.

Survey results

Key valuation risks

Which of the following are key valuation risks specific to your organization? Select all that apply.



PwC point of view

A sound valuation process begins with a robust definition of the key valuation risks that senior management and the board agree they need to monitor and mitigate. With the risks identified, management can develop controls that monitor and mitigate the risks, and management should provide reports to those charged with governance. We believe that the valuation risks highlighted in the chart above represent key risks for most real estate organizations and, if not appropriately monitored and controlled, significantly increase the potential for error in valuing portfolios.

Observations

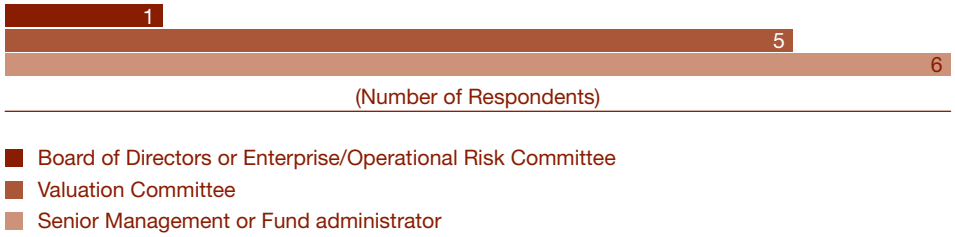
Seventy-five percent of respondents identified market volatility and changing liquidity as key valuation risks, followed by use of internal information, cited by 63%. These results are directionally in line with the other industry sectors. Some firms also identified concern about market comparables and determination of appropriate required rates of return as key valuation risks.

It is worth noting that many respondents did not identify a number of the risks listed in the survey question. To ensure that valuation risks are properly identified, asset management firms might consider holding sessions to identify potential risks, determine how to control recurring risks, and develop plans to address risks that could occur unexpectedly, such as a significant event.

As with all risk management operations, there is no foolproof method to eliminate valuation risks, but the risks can be minimized through the vigilance and oversight of senior management and boards. In an effective organization, these stakeholders never lose sight of the ultimate goal: valuations that treat all stakeholders fairly.

Responsibility for approving valuation policies and methodologies

Who is responsible for reviewing and approving specific valuation policies and methodologies? Select all that apply.



PwC point of view

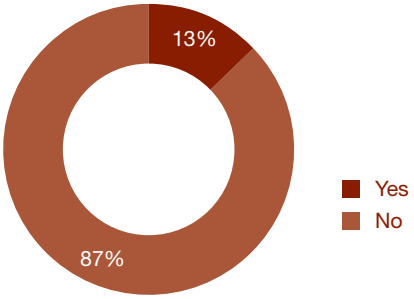
Consideration should be given to assigning a senior management group responsibility for managing and overseeing control and valuation policies and procedures. Members may include representatives from market risk management, credit risk management, financial control/product control groups, senior business management, tax, and legal. This group would prepare and review documentation and, where relevant, the board of directors or equivalent would be involved in approving the fair values.

Observations

Sixty-three percent of respondents identified a committee as being responsible for reviewing and approving valuation methodologies. The benefit of a committee approach lies in its ability to foster independence and objectivity, as committees can represent all key stakeholders in the organization. It may be difficult to achieve independence, for example, if the chief financial officer (CFO) alone has ultimate responsibility for reviewing and approving valuation methodologies.

Segregation of duties

Are asset valuations performed by member/members of management solely with responsibility for valuation with no other job responsibilities? In other words, is the valuation function independent from sourcing/acquisition, asset management, etc.?



PwC point of view

Management's valuation committee, as noted previously, normally consists of senior management with the responsibility to resolve valuation questions and oversee pricing vendors, administrators, and fund personnel involved in the valuation process. To reduce the potential for management bias, it is desirable for voting members of the valuation committee to be independent of the investment management function. Certainly, investment managers and other investment professionals may provide important input to the committee but in the spirit of governance independent of portfolio management it may be best to structure their involvement such that they are not serving in a decision-making role.

In our experience, the CCO or CRO typically does not serve in a decision-making capacity, more often attending valuation committee meetings only to observe and ensure that the process is performed in accordance with approved valuation policies and procedures. Organizationally, it is often appropriate to separate CCOs from valuation-related operational roles so that they face no conflicts of interest in reporting on compliance processes in which they actively participated.

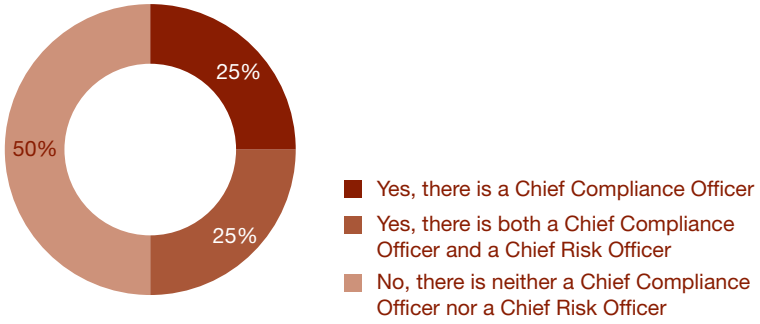
Finally, it is also important that any valuation committee member bring objectivity and good judgment to the deliberations and recognize that the charge is to be fair to all stakeholders, not to always seek the highest valuations (or, equally, not to be automatically conservative). Independence, accountability, and segregation of duties are important organizational concepts embraced by effective boards and managers and will continue to evolve as firms register and develop protocols under the new Dodd-Frank Act.

Observations

Eight-seven percent of respondents listed investment professionals as members of the valuation committee. As real estate asset managers register as investment advisers, they may need to reconsider the makeup of these committees. The SEC will be looking to see that independence, accountability, and segregation of duties are an integral part of management's control structure. Based on the survey responses, advisers may want to consider whether the current makeup of their committees is appropriate.

Existence of a CCO or CRO

Is there a Chief Compliance Officer (CCO) and/or a Chief Risk Officer (CRO) in your organization?



PwC point of view

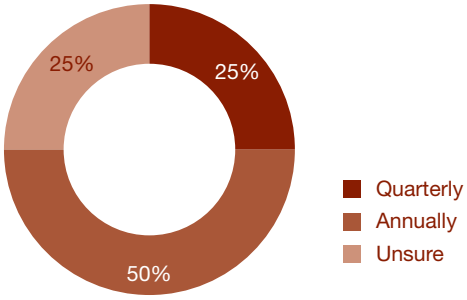
The CCO and CRO play critical roles in monitoring the effectiveness of the compliance policies and procedures of real estate asset managers, as well as monitoring compliance of service providers. Such monitoring includes periodically testing procedures to determine whether they were designed adequately and are operating effectively.

Observations

Half of respondents do not have a CCO or CRO within the organization. Although perhaps not surprising relative to current and historical operating models in the real estate industry, with the introduction of the Dodd-Frank Act that may require registration of some asset management firms, some real estate firms may need to adopt more stringent processes to address the regulator's requirements.

Frequency of valuation policy and procedure review

How often does the CCO/CRO review the valuation policies and procedures to ensure that they are effective and being adhered to?



PwC point of view

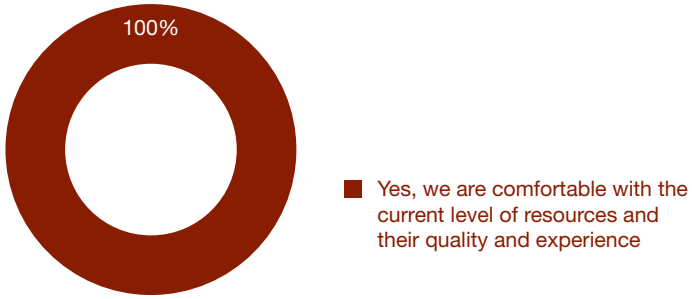
Firms with effective governance undertake a rigorous and regular process to determine fair values and report the results to senior management. Where fair value is a critical component of reported results, senior management should report the valuation results to the committee charged with governance over the funds.

Observations

Half of respondents indicated that policies and procedures are reviewed on an annual basis, which is consistent with industry trends. It is important that individuals who are independent from the execution of transactions review the valuation process. In assessing whether they are reviewing the process either too much or too little relative to their peers, firms might consider whether factors such as regulatory changes and market conditions should prompt a process review.

Resources performing valuation

Do you believe the group performing the valuation procedures has the appropriate level of resources, skills, and experience?



PwC point of view

Firms may want to consider having an appropriately qualified and experienced independent price verification (IPV) group be responsible for determining the fair value of real estate investments. Where fair value is a critical component of reported results, the IPV group can have dedicated quantitative professionals within the financial control or risk management group to deal with complex valuation. A key component of the IPV group's work is to verify the valuation model, independent of risk-taking activities, using highly experienced and qualified quantitative professionals. The group typically includes highly experienced and qualified quantitative professionals (e.g., product controllers, risk managers, valuation experts, and qualified accountants) with significant on-the-job experience as well as specialist training.

Observations

Although all of the respondents indicate they have the right valuation resources in place with the appropriate level of skill and experience, management may want to consider reassessing resource needs periodically. Portfolios are becoming more complex, and over time could require new skills.

PwC point of view

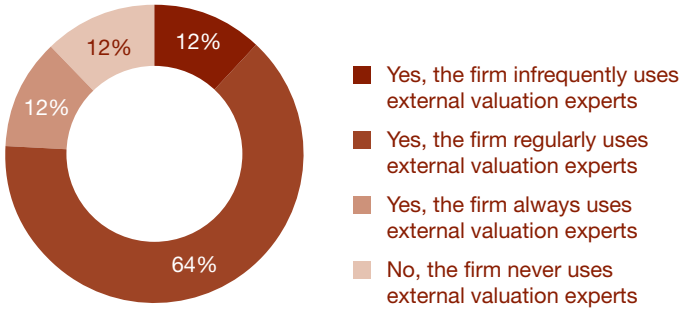
Real estate asset managers are increasingly turning to valuation experts to value complex instruments and to perform appraisals of properties where there are few market comparables. With the use of experts in a firm's valuation process, management is required to consider other control practices relating to the oversight of the experts. Firms may want to consider performing formal assessments periodically, using consistent criteria and metrics to rate these external experts. Periodic reviews could include an assessment of the experts' qualifications and reputation as well as their experience with new asset classes, their valuation process, and their valuation methodology. It is good practice to retain documentation of these reviews, to support conclusions made and actions taken. It is also a good practice to correspond with others in the industry to assist in evaluating the quality of the experts' past valuations.

Observations

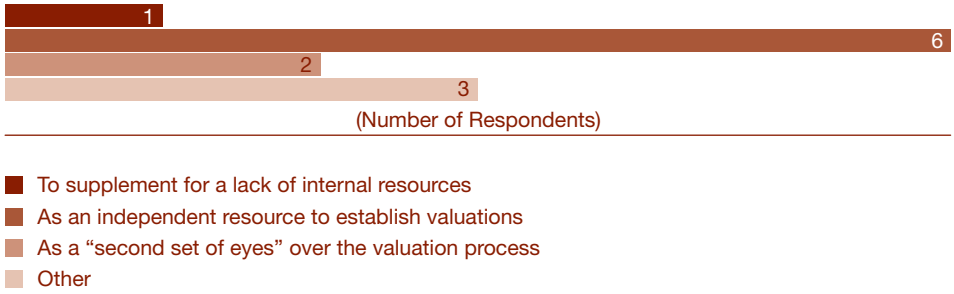
Eighty-eight percent of respondents rely on valuation experts and they indicated they do not use such experts because of a lack of internal resources. Rather, 25% use these experts as a "second set of eyes," while 75% use them as a resource to obtain independent valuations. Some respondents note that the use of an external expert is required by investors or other external parties. This is consistent with the previous observation about the importance of having the valuation process be independent from the transaction process.

Use of external valuation experts

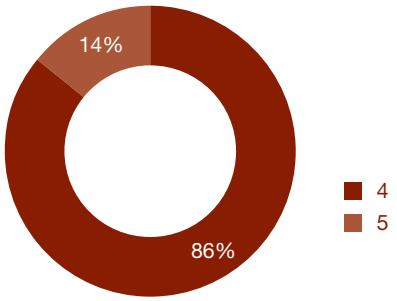
Does the firm use external valuation experts?



Why does the firm use external valuation experts? Select all that apply.

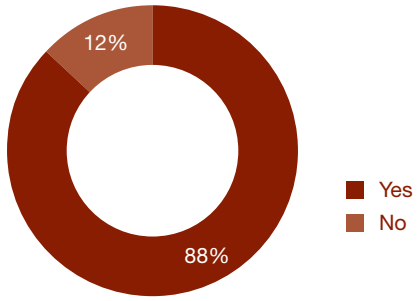


On a scale of 1–5, with 5 being the highest quality, how would you rate the quality of external experts your organization currently uses?



The valuation committee

Do you have an investment, valuation or similar committee to review valuations?



PwC point of view

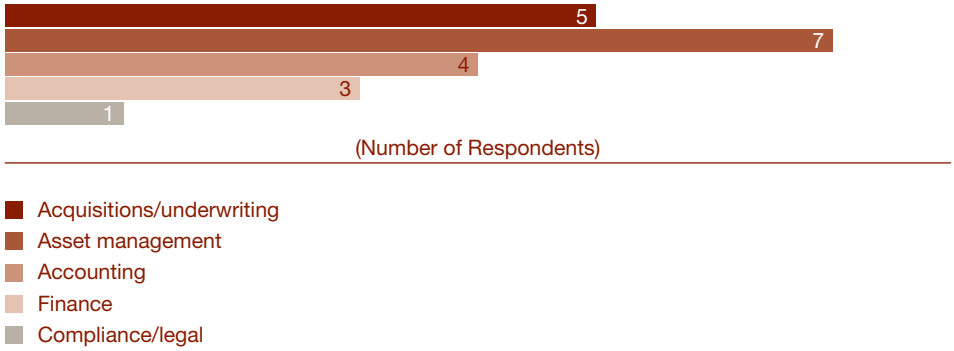
Consideration should be given to assigning a senior management group responsibility for managing and overseeing control and valuation policies and procedures. This group would report the results of its work directly to those charged with governance of the funds. Members may include representatives from market risk management, credit risk management, financial control/ product control groups, senior business management, tax, and legal. The group would prepare and review documentation and, where relevant, the board of directors or equivalent would be involved in approving the fair values.

Observations

Eighty-eight percent of respondents said they have a valuation committee in place. As this survey result suggests, valuation committees are becoming more commonplace, even among real estate asset managers. For management of those certain real estate firms that may now be required to register with the SEC, it will be increasingly important to demonstrate that the adviser has developed and implemented reasonable and effective valuation procedures, and that the procedures are being applied fairly and consistently. The presence of a committee that is independent and without conflicts of interest could assist in demonstrating to the regulators and the firm's investors that they are complying with these requirements.

Composition of the valuation committee

What disciplines within the organization are represented on such committee? Select all that apply.



PwC point of view

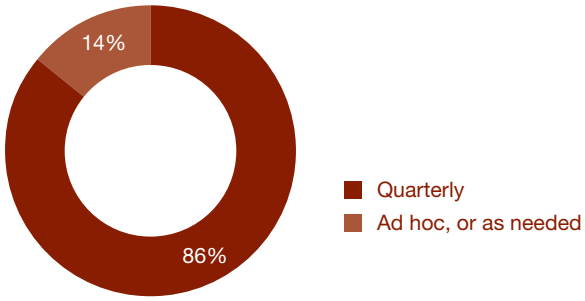
The valuation committee should consist of senior managers with responsibility to resolve valuation questions and exercise oversight responsibilities covering the valuation committee, administrators, and personnel involved in the valuation process. To reduce the potential for management bias, it is desirable that voting members of the valuation committee be independent of the investment management function. Investment managers and other investment professionals may provide important input to the committee but in the spirit of governance independent of portfolio management it may be best to structure their involvement such that they are not serving in a decision-making role.

Observations

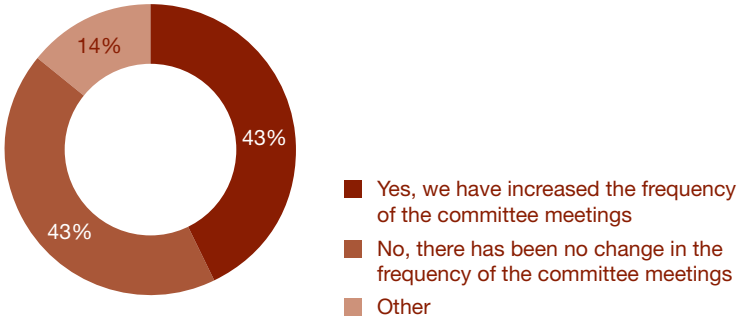
Independence and segregation of duties are important organizational concepts, and the SEC will be looking to see that these concepts are an integral part of management's control structure. In light of the survey responses, advisers may want to consider whether the composition of their valuation committees is adequate.

Frequency of valuation committee meetings

How often does the committee meet?



Has the frequency of the committee meetings changed as a result of the recent market activity/volatility?



PwC point of view

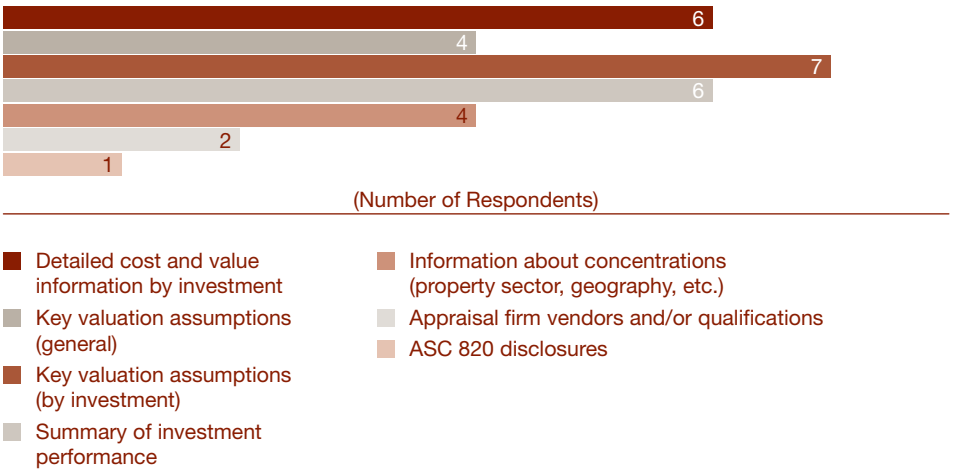
How often a committee meets is not as important as ensuring it meets as often as is appropriate. For example, when markets become more volatile, as we have seen in the past two years, and observable valuation inputs from market transactions become increasingly scarce, valuation committees may find it prudent to become more active and meet more frequently to determine how to provide the needed oversight.

Observations

Most valuation committees (86%) meet quarterly, according to our survey. When assessing the frequency of meetings, respondents might consider the state of the market and of their portfolios. For example, if the market shows significant dislocation and meeting frequency has not increased even temporarily, respondents may want to assess whether they are meeting frequently enough to properly manage the increased risk in the portfolio values. Fifty-seven percent of respondents have increased the frequency of meetings as a result of market activity or volatility. Given the recent market volatility of most real estate investments, this finding is as expected.

Analysis and documentation provided to the valuation committee

What analyses/documentation is provided to the committee on a regular basis? Select all that apply.



PwC point of view

As noted in the executive summary, there continues to be inconsistency in what analyses are provided to the valuation committee. As a starting point, management may consider including information about the following controls and processes in reports provided to the valuation committee:

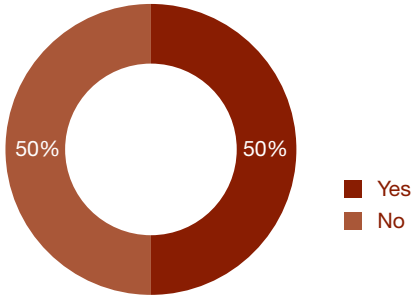
- A control to review external valuation services, if used
- An independent review of manual inputs
- A control to select appropriate market comparables
- A report to compare sales to previous valuations
- A control to assess the validity of data received from underlying real estate ventures
- A control to assess the relevance of models and methodologies used across the organization

Observations

Survey results indicate committees are generally well informed and are provided with sufficient information to carry out their fiduciary responsibilities. Management may want to consider reviewing new analyses or reports periodically to determine whether it is appropriate to provide the reports to the valuation committee and compare their current practices to any future applicable requirements of the Dodd-Frank Act.

The role of the board or the enterprise/operational risk committee

Is there an advisory committee or other governance body exclusive of management responsible for reviewing real estate asset valuations and valuation policies and procedures?



PwC point of view

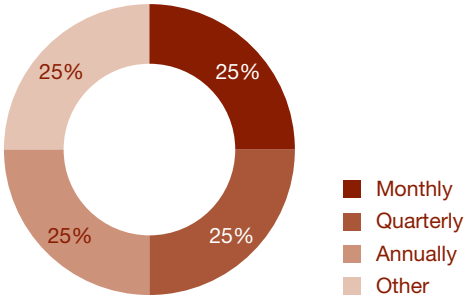
With respect to oversight of the valuation process, the SEC has indicated that the board of directors is responsible for establishing a fund's valuation policy, and the SEC expects directors or their equivalent to exercise independent, objective oversight and judgment when it comes to policy execution and related valuation and pricing procedures. Because the SEC places valuation responsibility on fund directors, this governance function normally resides with the board or the board's valuation committee. The board committee would establish the valuation policies and procedures to be executed by fund managers and pricing services, and normally it would review valuation results on a timely basis.

Observations

Half of the respondents have no enterprise or operational committee to oversee the valuation of investments. As noted previously, firms may want to consider having some oversight of the valuation process, even if the structure of the fund is a partnership and there is no formal board in place.

Frequency of reviewing and approving valuation service providers

How frequently does the governing body review and approve valuation service providers?



PwC point of view

The day-to-day responsibility for monitoring service providers rests with a fund's management. However, because fund directors have governance responsibility for valuation, this function normally resides with the board or the board's valuation committee. Accordingly, boards may need to consider their role in review and approval of valuation experts and service providers.

Observations

Respondents indicated diversity in how frequently they review valuation service providers. Some respondents noted that the governing body approves valuations annually but is not involved in the selection and approval of the valuation service provider. In assessing the timing of reviews, respondents might consider the state of the market and of their portfolios.

Conclusion

Real estate asset managers are grappling with the same valuation risks faced by other sectors of the asset management industry: market volatility and changing liquidity. They also are addressing the risks related to the use of internal information provided by deal teams to estimate fair values. Almost all of the real estate asset managers we surveyed (88%) have a valuation committee in place to manage and oversee valuation policies and procedures. While there is room for this sector to evolve its oversight capabilities further, the information our respondents provide to their valuation committees is largely consistent which is positive. However, with the changing regulatory landscape, some firms may want to reconsider the makeup of their committees as they prepare to register as investment advisers, in order to meet expectations of the regulators for independence and objectivity.

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