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SEC PROPOSES NEW FRAMEWORK FOR FUND VALUATION PRACTICES

The SEC has issued a proposed 1940 Act rule setting forth a new framework for funds' fair value determinations when a market value for a portfolio holding is not readily available. The authors discuss the proposed rule, focusing on six requirements for fair value determinations. They then turn to the definition of "readily available" market quotations and delegation of fair value determinations to fund advisers. They close with notes on rescission of prior SEC and staff guidance and the one-year transition period for the new rule.

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On April 21, 2020, the Securities and Exchange Commission proposed new Rule 2a-5 (the "Proposed Rule") under the Investment Company Act of 1940 setting forth a new framework for funds' fair value determinations when a market value for a portfolio holding is not readily available.¹ The Proposed Rule would define "readily available" market quotations, and, for the first time, provides a framework for how fund boards may delegate certain aspects of their statutory responsibility to value fund shares.

The SEC last comprehensively addressed fund valuation practices when it issued Accounting Series Release 113 ("ASR 113") and Accounting Series Release 118 ("ASR 118") in 1969 and 1970, respectively, so an update is long overdue. If adopted, the Proposed Rule would apply to all registered investment companies and business development

companies ("BDCs") regardless of their classification or sub-classification (e.g., both open-end mutual funds, ETFs, and closed-end funds).

EXISTING REGULATORY FRAMEWORK FOR FAIR VALUE DETERMINATIONS

In defining the "value" of a registered fund's securities for purposes of calculating its net asset value, Section 2(a)(41)(B) of the 1940 Act directs that a "fair value" be used when "market quotations are not readily available." This provision also expressly places the responsibility for determining a security's fair value on a fund's board of directors, "acting in good faith."² Rule 2a-4 under the 1940 Act defines the term "current net asset value" of a redeemable security issued by a

¹ The SEC release can be found at <https://www.sec.gov/rules/proposed/2020/ic-33845.pdf> (the "Proposing Release").

² With respect to unit investment trusts, because such entities do not have a board of directors or an investment adviser, the Proposed Rule would permit the trustee of a unit investment trust ("UIT") to conduct fair value determinations.

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registered investment company and, similar to Section 2(a)(41)(B), provides that “[p]ortfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.” While closed-end funds (including BDCs) are not subject to Rule 2a-4, Section 23(b) of the 1940 Act limits the ability of closed-end funds to sell shares of their common stock at a price below current net asset value.

PRIOR SEC AND STAFF GUIDANCE ON FUND BOARD’S FAIR VALUE DETERMINATIONS

The 1940 Act itself does not provide any guidance about the process that a fund board should follow to fair value securities nor does it provide guidance about the degree to which a board can rely on others in discharging this duty on a daily basis. The SEC last comprehensively addressed fund value practices 50 years ago in ASR 113 and ASR 118 in 1969 and 1970 respectively.³ While ASR 113 and ASR 118 acknowledged that boards could use the services of others to assist in the determination of fair value, they nevertheless emphasized that the ultimate responsibility of each fair value decision rested with the board and that “it is incumbent upon the [b]oard of [d]irectors to satisfy themselves that all appropriate factors relevant to the fair value of securities for which market quotations are not readily available have been considered.”⁴ In the intervening half century, the SEC staff provided further gloss on the responsibilities of fund boards’ obligations with respect to fair value but never squarely addressed

whether a fund board could assign the responsibility for making fair value determinations on a day-to-day basis to other parties, such as a fund’s investment adviser, whose skill and expertise and information are essential to each fair value determination.⁵

This lack of clarity about the degree to which a fund board could rely, with appropriate oversight and guidance, on a fund’s adviser or other party to make daily fair value determinations has been a point of debate among advisers and boards and their counsel.⁶ Varying board practices have emerged to bridge the gap between the board’s responsibility for fair value determinations under Section 2(a)(41)(B) and the practical reality that fair value determinations are a daily occurrence for many, if not most, fund complexes which must, for operational and commercial reasons, be made in a prompt and efficient manner post market close each day. In addition, and as the Proposing Release acknowledges, since 1970, the increasing complexity of the types of securities in which funds invest has only added to boards’ necessary reliance on advisers’ expertise in making fair value determinations.⁷

The Proposed Rule seeks to reflect and codify the approach taken by fund boards with respect to their valuation duties by permitting boards to assign the determination of fair value of a fund’s portfolio securities to the fund’s investment adviser. As discussed below, the board’s assignment to the investment adviser would be subject to certain conditions and board

³ Statement Regarding “Restricted Securities,” ASR 113 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, ASR 118 (Dec. 23, 1970). ASR 113 addressed a number of federal securities law and accounting topics related to the purchase of restricted securities by funds, including how to determine fair value for such securities. ASR 118 expressed the SEC’s views on certain valuation matters, including accounting and auditing, as well as the role of the board in the determination of fair value.

⁴ ASR 118 at 19988.

⁵ See Proposing Release at 67 for a list of the pertinent SEC staff letters and guidance.

⁶ For example, the SEC has stated that a fund’s board of directors “may not delegate to others the ultimate responsibility of determining the fair value of any asset not having a readily ascertainable market value[.]” *In the Matter of Seaboard Associates, Inc.*, Investment Company Act Release No. 13890 (Apr. 16, 1984). On the other hand, in ASR 118 the SEC stated that a fund’s board of directors “may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board’s direction.” Investment Company Act Release No. 6295 (ASR 118) (Dec. 23, 1970).

⁷ Proposing Release at 14.

oversight obligations meant to enable the board to satisfy its obligations to determine fair value in good faith.

FAIR VALUE DETERMINATIONS UNDER THE PROPOSED RULE

The Proposed Rule does not lay out precise criteria that should be used in fair value determinations nor does it describe specific factors that must be applied in valuing different types of instruments. The Proposed Rule does, however, provide a required framework and necessary process elements for fair value determinations to be made by a fund's board in good faith.

Under the Proposed Rule, any determination of fair value in good faith would require:

- **Identifying and Managing Material Valuation Risks and Conflicts of Interest** — The Proposed Rule would mandate (1) an assessment of the material risks and material conflicts of interest that could affect a particular fair value determination and (2) the implementation of a fair value decision-making process that manages those risks and conflicts of interest.⁸ The Proposing Release sets out a non-exhaustive list of the types and sources of valuation risks, including: (1) the types of investments held or intended to be held by the fund; (2) potential market or sector shocks or dislocations (*e.g.*, a significant change in short-term volatility or market liquidity); (3) the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the investment adviser; (4) the proportion of the fund's investments that are fair valued, and their contribution to the fund's returns; (5) reliance on service providers that have more limited expertise in relevant asset classes; (6) the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which third-party service providers rely on their own service providers; and (7) the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.⁹
- **Establishing Fair Value Methodologies** — The Proposed Rule would require, among other things,

determining (1) the key inputs and assumptions specific to the fair valuation of each asset class or portfolio holding and (2) the methodologies that will apply to new types of investments in which the fund intends to invest. The Proposing Release notes that it would be insufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that the options are valued using a Black-Scholes model, without providing further detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology's inputs and assumptions, and a description of how the calculation is to be performed (which may be, but is not required to be, in the form of a formula).¹⁰

- **Testing Fair Value Methodologies** — The Proposed Rule would also require that the selected methodologies be consistently applied and periodically reviewed for appropriateness and accuracy, and adjusted, if necessary. The Proposed Rule would require the identification of both the specific testing methods to be used and the minimum frequency of the testing. For instance, the results of back-testing, or calibration, or a change in circumstances specific to an investment could necessitate adjustments to a fund's fair value methodologies. The Proposing Release states that "for a fair value methodology to be appropriate under the [Proposed Rule], it must be determined in accordance with U.S. GAAP."¹¹ The SEC noted that the tests to be performed, and the frequency with which they should be administered, are facts and circumstances dependent for each fund and thus should be determined by the fund's board or adviser. The Proposing Release states that the results of back-testing and calibration can be particularly useful in identifying trends and may also have the potential to assist in identifying issues with a methodology applied by a fund service provider (including a service provider's poor performance or potential conflicts).¹²
- **Establishing a Process for the Approval, Monitoring, and Evaluation of Pricing Services and Other Third-Party Vendors** — The Proposed Rule would require a substantive process for approving the use of a pricing service and the ongoing monitoring and periodic evaluation of the

⁸ Other than identifying material conflicts of interest, the Proposed Rule does not identify the specific valuation risks to be addressed, but does include a non-exhaustive list of the types or sources of valuation risks as noted above.

⁹ Proposing Release at 17-18.

¹⁰ *Id.* at 20.

¹¹ *Id.* at 58.

¹² *Id.* at 24.

pricing service. The list of factors a fund’s board or investment adviser should generally take into consideration include: (1) the qualifications, experience, and history of the pricing service; (2) the valuation methods or techniques, inputs, and assumptions¹³ used by the pricing service for different classes of holdings, and how they are affected as market conditions change; (3) the pricing service’s process for considering price challenges, including how the pricing service incorporates information received from pricing challenges into its pricing information; (4) the pricing service’s potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and (5) the testing processes used by the pricing service. The Proposed Rule would also require a board, or the adviser, to establish criteria for when, and a process for how, a vendor price is challenged.¹⁴

- **Policies and Procedures** — While the Proposed Rule would mandate written compliance policies and procedures specific to new Rule 2a-5, the Proposing Release acknowledges that Rule 38a-1 under the 1940 Act¹⁵ would apply to a fund’s obligations under the Proposed Rule, and to the extent that an adviser’s policies and procedures under the Proposed Rule “would otherwise be duplicative of fund valuation policies under Rule 38a-1, a fund could adopt the [R]ule 2a-5 policies and procedures of the adviser in fulfilling its Rule 38a-1 obligations.”¹⁶
- **Maintaining Certain Records** — The Proposed Rule would require the maintenance of certain records, including appropriate documentation to support fair value determinations for at least five years from the time the determination was made, the first two years in an easily accessible place.

Appropriate documentation includes information regarding the specific methodologies applied, and the assumptions and inputs considered when making fair value determinations, as well as any necessary or appropriate adjustments in methodologies.

“READILY AVAILABLE MARKET QUOTATIONS”

Under Section 2(a)(41) of the 1940 Act, if a market quotation is readily available for a portfolio holding, the holding must be valued at the market value, but where market quotations are “not readily available,” the holding must be fair valued as determined in good faith by the fund’s board. The Proposed Rule would provide that a market quotation is readily available only when that quotation is a “quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.”¹⁷ The Proposing Release states that a “quote would be considered unreliable under proposed [R]ule 2a-5(c) in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security.”¹⁸

The Proposing Release forcefully reiterates the SEC’s current view that evaluated prices are not, by themselves, readily available market quotations. This statement may have implications for the use of such prices in other contexts.

In particular, the Proposed Rule’s definition of “readily available market quotations” and the discussion in the Proposing Release of evaluated prices may portend future changes to Rule 17a-7 under the 1940 Act and the conditions governing the ability of registered funds to cross-trade fixed income securities.¹⁹ Rule

¹⁷ *Id.* at 58.

¹⁸ *Id.*

¹⁹ By way of background, Section 17(a) of the 1940 Act prohibits an affiliated person of a registered investment company, or any affiliated person of such person, from selling securities to, or purchasing securities from, the investment company. Rule 17a-7 under the 1940 Act generally exempts from the prohibition of Section 17(a) certain transactions between investment companies that are affiliated solely by reason of having a common investment adviser and/or board of trustees, subject to certain conditions. Specifically, to comply with Rule 17a-7, the transaction generally must: (1) be for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available; (2) be effected at the independent current market price of the security; (3) be consistent with the investment company’s investment

¹³ Per the Proposing Release, in considering a pricing service’s valuation methods or techniques, inputs, and assumptions, the fair value policies and procedures generally should address whether the pricing service is relying on inputs or assumptions provided by the investment adviser. *Id.* at 25.

¹⁴ *Id.* at 26.

¹⁵ Rule 38a-1 requires, in part, a fund’s board of directors to approve the fund’s compliance policies and procedures, including those relating to fair valuation, and those of each investment adviser and other specified service providers based upon a finding by the board that the policies and procedures are reasonably designed to prevent violations of the federal securities law. Rule 38a-1(a)(2).

¹⁶ Proposing Release at 27.

17a-7 is available only for securities for which “market quotations are readily available.” If the definition in the Proposed Rule is adopted as proposed, it could immediately be imputed into the application and scope of Rule 17a-7, which uses identical language, thus impacting a fund’s ability to cross-trade.

Many fund complexes rely on pricing services to provide prices at which fixed income securities may be cross-traded, in reliance on SEC no-action letters.²⁰ While those letters expressly address the ability to cross-trade municipal bonds, some rely on these letters to use pricing service valuations to cross-trade other types of fixed income securities as well. However, as noted above, the Proposed Rule defines “readily available market quotation” as “a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date,” and reiterates the proposition (first included in the 2014 Money Market Fund Release²¹) that “evaluated prices provided by pricing services are not, by themselves, ‘readily available’ market quotations.”²² This statement may raise questions about whether and to what extent vendor prices may form the basis for cross trades under Rule 17a-7. We understand this to mean that there needs to be a separate determination of whether market prices are readily available, apart from the provision of an evaluated price from a vendor, before bonds are cross-traded. Presumably the SEC is not implying that a vendor price, which may be based on actual trades and real time quotations, *cannot* be deemed a readily available market quotation, but this discussion could benefit from clarification in the adopting release.

DELEGATION TO ADVISERS

As noted above, the SEC has never definitively stated that a fund’s board of directors may delegate the responsibility for fair value determinations to the fund’s investment adviser. The Proposing Release acknowledges, however, for practical reasons, a fund’s board of directors is typically not directly involved in the

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objectives and policies; and (4) trigger for the fund no brokerage commission, fee (except for customary transfer fees), or payment of other remuneration.

²⁰ *Federated Municipal Funds*, SEC No-Action Letter (pub. avail. Nov. 20, 2006); *United Municipal Bond Fund*, SEC No-Action Letter (pub. avail. July 30, 1992).

²¹ Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014).

²² Proposing Release at 59.

performance of the day-to-day valuation tasks required to determine fair value; rather such tasks are performed by a fund’s investment adviser (or other service providers), subject to the board’s supervision and oversight.²³

The Proposed Rule specifically allows boards to assign responsibility for fair value determinations to the fund’s adviser (or one or more sub-advisers), subject to board oversight and certain reporting, recordkeeping, and other conditions designed to allow the board to effectively oversee the adviser’s fair value determinations. An adviser assigned fair valuation responsibilities would carry out such responsibilities in accordance with the requirements set forth above, subject to the following additional conditions:

- **Board Oversight.** At least quarterly, the adviser would be required to provide a written assessment of the adequacy and effectiveness of the adviser’s process for determining fair value. Such report would be required to include, among other things, a description of the assessment and management of material valuation risks, including material conflicts of interest. The Proposing Release directs fund boards to take a “skeptical and objective” view of the delegated adviser’s fair value determinations. Further, the Proposing Release states that board oversight cannot be a passive activity, and that a fund’s directors should ask questions, seek relevant information, and seek to identify opportunities to improve the adviser’s process. A fund board should also request follow-up information when appropriate and take reasonable steps to see that matters identified are adequately addressed.²⁴

The Proposing Release states that fund boards should utilize the appropriate level of scrutiny dependent upon each fund’s valuation risk, including the extent to which fair value of the fund’s investments depends on subjective inputs. According to the Proposing Release, a board’s level of scrutiny would likely be different if a fund invests in publicly traded foreign companies than if the fund invests in private early-stage companies. The SEC expects that, as the level of subjectivity increases and the inputs and assumptions used to determine

²³ For instance, for a fund that issues redeemable securities, value must be determined at least once each business day for each portfolio holding in order to calculate the fund’s net asset value. 17 CFR 270.22c-1(b)(1). Making such determinations would be impractical for a fund’s board of directors.

²⁴ Proposing Release at 35.

fair value move away from more objective measures, a fund's board's level of scrutiny would increase accordingly.²⁵ Additionally, fund boards should (1) probe the appropriateness of the adviser's fair value processes, in particular, the financial resources, technology, staff, and expertise of the adviser, and the reasonableness of the adviser's reliance on other fund service providers, relating to valuation and (2) consider the investment adviser's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available to the chief compliance officer relating to fair value.²⁶ While a fund's board can reasonably rely on the information provided to it by the investment adviser and its other service providers in fulfilling its oversight obligation, the Proposing Release states that "it is incumbent on the board to request to review such information as may be necessary to be fully informed of the adviser's process for determining the fair value of fund investments."²⁷

Further, in connection with its obligations under the 1940 Act and as fiduciaries, a fund's board of directors is expected to seek to identify any potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage any such conflicts.²⁸ As part of its oversight of the investment adviser, the fund's board should understand the role of, and inquire about any conflicts of interest regarding, any other service providers utilized by the adviser as part of the fair valuation process, and satisfy itself that any such conflicts are appropriately managed.²⁹

- **Prompt Reporting.** The adviser would be required to promptly report to the board (*i.e.*, no later than three business days after the adviser becomes aware of the matter) in writing on matters associated with the adviser's process that materially affect or could have materially affected, the fair value of the fund's investments.³⁰ This would include a significant deficiency or material weakness in the design or implementation of the adviser's fair value process or material changes in the fund's valuation risk.³¹ The

Proposing Release notes that some situations may require an immediate report.³²

- **Specification of Responsibilities and Reasonable Segregation.** The adviser would be required to specify the titles of any persons responsible for fair value determinations, as well as the particular functions for which such persons are responsible and to reasonably segregate the fair value determination process from portfolio management to avoid conflicts.³³ The Proposing Release noted that a fund should consider the extent of influence that a portfolio manager may have on the administration of the fair value process "and seek to provide independent voices and administration of the process as a check on any potential conflicts of interests to the extent necessary."³⁴
- **Recordkeeping.** The fund would be required to maintain additional records relevant to the assignment, including copies of reports provided to the fund's board and a specified list of investments or investment types that have been assigned.³⁵

As drafted, the Proposed Rule would permit a fund board to assign the responsibility for daily fair value determinations only to a fund's investment adviser or advisers but not to other service providers. The Proposing Release solicits input on whether Rule 2a-5 should permit a board to assign fair value determinations to persons other than a fund's adviser (or advisers).³⁶ A fund's adviser, in many cases, is the most logical assignee for fair value responsibility and this requirement recognizes the role advisers play in current practice. However, in certain instances, a fund's adviser may not necessarily be the agent best positioned to make fair value determinations. For example, for index funds, exchange-traded funds, and other funds that use a quantitative investment approach, the adviser may not have the expertise to address idiosyncratic and security-specific fair value events because it may not have portfolio managers, analysts, or others who understand the security's issuer in sufficient detail to provide an

²⁵ *Id.*

²⁶ *Id.* at 37.

²⁷ *Id.*

²⁸ *Id.* at 36.

²⁹ *Id.* at 37.

³⁰ *Id.* at 49.

³¹ *Id.*

³² *Id.* at 50.

³³ *Id.* at 53.

³⁴ *Id.* at 54.

³⁵ *Id.* at 56.

³⁶ *Id.* at 38.

accurate analysis of the likely impact the event has had on the value of the security in the absence of any market indicators of value. In those cases, a board might be better served by relying on other valuation experts, such as accounting firms or valuation consultants.

RESCISSION OF PRIOR SEC AND STAFF GUIDANCE

Upon adoption of the Proposed Rule, the SEC would rescind ASR 113 and 118, each of which provides guidance on the role of a fund's board in fair value determinations, as well as guidance on certain accounting and auditing aspects of valuation.³⁷ The rescission of such guidance would eliminate the requirement for the independent auditor to verify all quotations of securities with readily available market quotations at the balance sheet date. According to the Proposing Release, due to developments in the Financial Accounting Standards Board ("FASB") accounting standards, "fund-specific accounting guidance for recognition, measurement, and disclosure provided in those statements may no longer be necessary."³⁸ Relatedly, SEC Staff letters addressing a board's role in the fair valuation process and other matters covered by the Proposed Rule would also be withdrawn.³⁹ If adopted, the Proposed Rule would become effective one year after the publication of the final rule in the Federal Register.

TIMELINE AND COMMENT PERIOD

The SEC proposed a one-year transition period for the Proposed Rule. Comments on the Proposed Rule were due by July 21, 2020, representing a longer-than-typical comment period.

CONCLUSION

The Proposed Rule strikes an appropriate balance between flexibility and accountability. It creates a clear framework for a board's ability to rely on the fund's investment adviser for managing and making fair value determinations, but also includes clear expectations for meaningful board oversight and supervision. It reflects an understanding that a fund's board is, generally, not in the best position to fairly value individual portfolio holdings. For appropriate and responsible delegation, however, investment advisers likely will have to closely examine and modify their own valuation procedures, adding a mechanism for "prompt" reporting to the fund's board of any issues that arise in the fair valuation process, as well as the designation of certain personnel to hold such individuals accountable to the board. The Proposed Rule would also formalize a board's responsibility for approval of pricing vendors, which may result in greater scrutiny and input into the methodologies used by those vendors. ■

³⁷ *Id.* at 64.

³⁸ *Id.* at 61.

³⁹ *Id.* at 67.