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SEC Proposes New Valuation Rule for Registered Funds and BDCs

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On April 21, 2020, the Securities and Exchange Commission (the "SEC") proposed new Rule 2a-5 (the "proposed rule") under the Investment Company Act of 1940, as amended (the "1940 Act").[1] The proposed rule establishes requirements for determining fair value "in good faith" for purposes of the 1940 Act[2], which is a board of directors ("board") statutory responsibility. Significantly, the proposed rule would permit a board of a registered investment company or a business development company (collectively, "funds") to assign fair value determinations to the fund's investment adviser.[3] This authority is permitted only if the board establishes a framework through which the board is able to oversee the investment adviser's valuation practices effectively. The principal elements of this framework are:

- assessing and managing valuation risks;
- establishing and applying fair value methodologies;
- testing fair value methodologies;
- adopting and implementing fair value policies and procedures; and
- recordkeeping.

If a fund board assigns fair value determination responsibilities to the investment adviser, the investment adviser would create the framework in the first instance.[4]

The proposed rule also defines "readily available market quotations." Finally, the SEC proposes to rescind certain previously-issued guidance on the role of fund boards in determining fair value and the accounting and auditing of fund investments.

Background

Importance of Accurate Valuation of Fund Investments. In the Proposing Release, the SEC discusses the importance of proper valuation of fund investments and the corresponding calculation of the fund's net asset value ("NAV"), including: the purchase and sale of fund shares at fair prices to avoid dilution of shareholder interests; the accuracy of funds' asset-based and performance-based fee calculations and other asset-based expense calculations; the accuracy of disclosures of fund fees, performance, NAV and portfolio holdings; the accuracy of monitoring for compliance with fund investment policies and limitations; and accurate accounting and financial reporting.

Evolution of Markets and Fund Investments. The Proposing Release discusses the considerable evolution of markets and in fund investment practices since the SEC last comprehensively addressed valuation under the 1940 Act in a pair of releases issued in 1969 and 1970.[5] The SEC notes that funds now invest in a greater variety of securities and other instruments (some of which did not exist in 1970), which may present different valuation challenges. The SEC further notes the greatly enhanced availability of pricing-related information and technologies that have developed to facilitate enhanced price discovery and transparency, and that many funds engage third-party pricing services to provide evaluated prices to assist in the determination of fair values of certain types of investments (primarily debt and derivative instruments).

Evolution of the Regulatory Environment. The SEC cites three major regulatory developments since 1970 that have fundamentally altered how boards, advisers, independent auditors and other market participants address valuation under the federal securities laws.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002, among other things, established the Public Company Accounting Oversight Board (the "PCAOB"), which oversees audits of companies subject to the federal securities laws. The PCAOB has the authority to establish or adopt professional standards, including audit and quality controls standards, as well as criteria for an accounting standard-setting body's work product to be recognized as "generally accepted" for the purpose of the federal securities laws.

Rule 38a-1 under the 1940 Act. Rule 38a-1, adopted in 2003,[6] requires, among other things, funds to adopt and implement written compliance policies and procedures reasonably designed to prevent violation of the federal securities laws and to designate a chief compliance officer ("CCO") responsible for their administration. In the release adopting Rule 38a-1, the SEC provided specific areas that it stated the rule requires fund fair valuation policies and procedures to address. The requirements for policies and procedures in the proposed rule, if adopted, would encompass the requirements for policies and procedures as discussed in the Rule 38a-1 adopting release.

ASC Topic 820. Finally, in 2009, the Financial Accounting Standards Board ("FASB") codified Accounting Standards Codification Topic 820 ("ASC Topic 820"),[7] which defines the term "fair value" for purposes of accounting standards and establishes a framework for the recognition, measurement and disclosure of fair value under U.S. generally accepted accounting principles ("GAAP").

Fair Value Determination Requirements of the Proposed Rule

The proposed rule provides the following requirements for determining fair value in good faith for purposes of Section 2(a)(41) of the 1940 Act and, as applicable, Rule 2a-4 thereunder. In the Proposing Release, the SEC states that it formulated these requirements based on its understanding of current practices used by funds to determine the fair value of their investments. As stated above, a fund's board may assign the fair value determination (and therefore fulfillment of the requirements listed below) to the fund's adviser.

- *Assess and manage risks*—periodically assessing any material risks associated with the determination of the fair value of fund investments ("valuation risks"), including material conflicts of interest, and managing such valuation risks. Although the proposed rule does not identify the specific valuation risks to be addressed (other than conflicts of interest), the following non-exhaustive list of the types or sources of such risks was provided in the Proposing Release:
    - the types of investments held or intended to be held by the fund;
    - potential market or sector shocks or dislocations;
    - the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;

    - the proportion of the fund's investments that are fair valued and their contribution to the fund's returns;
    - reliance on service providers that have more limited expertise in relevant asset classes; the use of 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;
    - inappropriate methods for determining and calculating fair value or the application of such methods inconsistently or incorrectly; and
    - changes in fund investments, significant changes in a fund's investment strategy or policies, market events and other relevant factors.

- *Establish and apply fair value methodologies*, taking into account the fund's valuation risks:
    - selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments, including (1) the key inputs and assumptions specific to each asset class or portfolio holding and (2) which methodologies apply to new types of investments in which the fund intends to invest;[8]
    - periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary adjustments thereto;
    - monitoring for circumstances that may necessitate the use of fair value; and
    - establishing criteria for determining when market quotations are no longer available.

- *Test fair value methodologies*—testing the appropriateness and accuracy of the methodologies selected, including identifying the testing methods to be used and the minimum frequency of such testing.
- *Evaluate pricing services*—overseeing any pricing service providers, including establishing the (1) process for the approval, monitoring and evaluation of such providers and (2) criteria for initiating price challenges. The Proposing Release states that a process for approval, monitoring and evaluation of pricing services generally should take into consideration factors such as:
    - the qualifications, experience and history of the pricing service;
    - the valuation methods, inputs and assumptions used for different classes of holdings and how they are affected as market conditions change;

    - the pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;
    - the pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and
    - the testing processes used by the pricing service.

- *Fair value policies and procedures*—adopting and implementing written policies and procedures[9] for the fair value of fund investments that are reasonably designed to achieve compliance with the above requirements. The Proposing Release notes that Rule 38a-1 would encompass a fund's compliance obligations with respect to the proposed rule and would require a board to oversee compliance with the rule.
- *Recordkeeping*—maintaining appropriate documentation to support fair value determinations, including the specific methodologies applied and the assumptions and inputs considered, and copies of the fair value policies and procedures.

Fund Board May Assign Fair Value Determinations to the Fund's Adviser

The proposed rule would permit a fund board to assign fair value determinations to the fund's investment adviser (or one or more sub-investment advisers) if the board establishes a framework through which the board is able to oversee the investment adviser's valuation practices effectively, including receiving certain reporting from the investment adviser.

Board Oversight and Reporting. Although a board may assign fair value determinations to an adviser, the proposed rule would require the board to satisfy its statutory obligation under Section 2(a)(41) by overseeing the adviser. In the Proposing Release, the SEC emphasized that:

> [O]versight cannot be a passive activity. Directors should ask questions and seek relevant information. . . . The proposed rule would require the adviser to report to the board with respect to matters related to the adviser's fair value process . . . Boards should also request follow up information when appropriate and take reasonable steps to see that matters identified are addressed.

Board Oversight. The Proposing Release states that, consistent with obligations under the 1940 Act and as fiduciaries, fund boards should seek to identify, monitor and take reasonable steps to manage conflicts of interest and act as a meaningful check on conflicts of the adviser and other service providers involved in fair value determinations. The Proposing Release further states that boards should consider the type, content and frequency of the reports they receive and that:

> [W]hile a board can reasonably rely on the information provided to it in summaries and other materials provided by the adviser and other service providers in conducting its oversight, it is incumbent on the board to request and review such information as may be necessary to be fully informed of the adviser's process for determining the fair value of fund investments.

The SEC stresses that if a board becomes aware of material matters, whether identified by the board itself, the CCO, the adviser or another party, the board must inquire about such matters and take reasonable steps to see that they are addressed.

Board Reporting. In the Proposing Release, the SEC recognized that boards currently receive a variety of reports from the adviser about the fund's valuation process and notes that boards should receive relevant and tailored information to provide the board with sufficient insight and data to properly exercise its oversight as contemplated by the proposed rule. The proposed rule would require the adviser to provide reports to include such information as may be reasonably necessary for the board to evaluate the matters covered in the reports, in order to provide the board with sufficient context and enough information to determine whether to ask additional questions or request additional information, as appropriate.

To facilitate board oversight, the proposed rule requires the adviser to report to the board, at least quarterly, an assessment of the adequacy and effectiveness of the adviser's process for determining fair value, including at a minimum, a summary of description of:

- an assessment and management of material valuation risks, including any material conflicts of interest of the adviser and any other service provider;
- any material changes to or deviations from the fair value methodologies established;

- the results of the testing of fair value methodologies required under the proposed rule;
- the adequacy of resources allocated to the process for determining fair values, including any material changes to the roles or functions or the persons responsible for determining fair value;
- any material changes to the adviser's process for selecting and overseeing pricing services, as well as material events related to the adviser's oversight of pricing services, such as changes in the service providers or price overrides; and
- any other materials requested by the board related to the adviser's process for determining fair value.[10]

In addition to the periodic reporting, the proposed rule would require the adviser to notify the board promptly (but in no event 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 assigned portfolio of investments, including a significant deficiency or a material weakness in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks.

Specification of Functions. The proposed rule would require the adviser to specify the titles of the persons responsible for determining the fair value of the assigned investments (including initiating price challenges), including by specifying the functions for which such person is responsible. This could include specifying a valuation committee or similar body. The adviser must reasonably segregate the process of making fair value determinations from the portfolio management of the fund.

Records of Assignment. Finally, in addition to the records that must be maintained with regard to the good faith determination of fair value generally, a fund must keep records of (1) the reports and other information provided to the board as required above and (2) a specified list of the investments or investment types whose fair value determination has been assigned to the adviser pursuant to the proposed rule.

Readily Available Market Quotations

The Proposing Release notes that the board's responsibility to determine the fair value of a portfolio holding depends on whether or not market quotations are "readily available." Currently, neither the 1940 Act nor the rules thereunder define "readily available" in Section 2(a)(41). The SEC states that it understands that industry practice has developed to incorporate many of the concepts of ASC Topic 820 when evaluating whether market quotations are readily available. The proposed rule would provide that a market quotation is readily available with respect to a portfolio holding 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. The Proposing Release states that a quote would be considered unreliable under the proposed rule (and therefore require fair valuation) in the same circumstances where it would require adjustment under GAAP or where GAAP would require consideration of additional inputs in determining the value of the portfolio holding. The SEC notes that it has previously stated that evaluated prices are not, by themselves, readily available market quotations, and that "indications of interest" and "accommodation quotes," for example, would not be readily available market quotations for the purposes of the proposed rule.

Rescission of ASR 113 and ASR 118 and Certain Staff Guidance

Referring to the regulatory environment developments described above, the SEC states in the Proposing Release that it believes accounting standards from FASB have modernized the approach to accounting topics addressed in ASR 113 and ASR 118 so that fund-specific SEC guidance on these topics may no longer be necessary. For example, the SEC states that it no longer believes that it is necessary for an auditor to verify quotations for securities with readily available market quotations at the balance sheet date, per its guidance in ASR 118.[11] In addition, the SEC states that it believes that the measurements concepts under ASC Topic 820 are consistent with the 1940 Act and the SEC's prior statements that fair value is the amount that an owner of a portfolio holding might reasonably expect to receive upon its "current sale."

In addition to the two ASRs, the SEC proposes to rescind certain SEC staff no-action letters and other written staff guidance in the area of valuation.[12] The Proposing Release requests comment on whether any other staff letters or guidance should be rescinded or withdrawn (or, alternatively, codified), but does not reference or request comment on the rescission or withdrawal of any SEC releases or other written guidance.[13]

Transition Period and Request for Comments

The Proposing Release states that the SEC would expect to provide a one-year transition period while funds and advisers prepare to come into compliance with the proposed rule. The SEC requests comment on numerous matters related to the requirements of the proposed rule, with comments due on or before July 21, 2020.

[1] *Good Faith Determinations of Fair Value*, Investment Company Act Release No. 33845 (Apr. 21, 2020) (the "Proposing Release"), available at https://www.sec.gov/rules/proposed/2020/ic-33845.pdf.

[2] Section 2(a)(41) of the 1940 Act defines, in relevant part, the "value" of a fund's assets to be: (1) for securities for which market quotations are readily available, the market value of such securities; and (2) for other securities and assets, fair value "as determined in good faith by the board of directors." (emphasis added)

[3] A board also may assign fair value determinations to one or more sub-investment advisers. Reference to assignment to an "investment adviser" or "adviser" in this Client Alert refers to assignment to an investment adviser and/or one or more sub-investment advisers, as applicable.

[4] A board may choose not to assign fair value determinations and instead make fair value determinations in compliance with the same requirements in the five areas outlined above. For unit investment trusts ("UITs"), which do not have boards of directors or investment advisers, the UIT's trustee would conduct the fair value determinations under the proposed rule.

[5] SEC Accounting Series Release No. 113, *Statement Regarding Restricted Securities* (Oct. 21, 1969) ("ASR 113") and SEC Accounting Series Release No. 118, *Accounting for Investment Securities by Registered Investment Companies* (Dec. 30, 1970) ("ASR 118") (together acknowledging that the board itself does not have to perform each of the specific tasks required to calculate fair value but that the board is to choose, and continuously review, the valuation methods used; consider all appropriate relevant factors; and carefully review any findings by individuals providing technical assistance, all in order for the directors to satisfy themselves that the resulting values are fair).

[6] A similar companion rule for investment advisers was adopted at the same time under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), requiring, among other things, advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act.

[7] In 2006, FASB issued *Fair Value Measurements*, Statement of Financial Accounting Standards No. 157, and codified it in 2009 as ASC Topic 820.

[8] The Proposing Release refers to ASC Topic 820, which describes the market, income and cost approaches to valuation, as well as valuation techniques and methods to measure fair value, and states that a methodology used for purposes of determining fair value must be consistent with ASC Topic 820 and should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

[9] The Proposing Release contemplates that fair value policies and procedures would be adopted and implemented by the adviser, subject to board oversight, if the board assigns the responsibility for fair valuation determinations to the adviser.

[10] The Proposing Release includes a list of additional items a board could review and consider, if relevant, including summaries of price challenges; specific testing data; reports on portfolio holdings for which there have been no change in price or for which investments have been held at cost for an extended period of time ("stale" prices); reports on pricing errors; reports on the adviser's due diligence of pricing services used by the fund; results of testing by the fund's auditor provided to the audit committee; reports analyzing trends in the number of the fund's portfolio holdings that were fair valued, as well as the percent of the fund's holdings that were fair valued; and reports on securities whose fair values were determined based on information provided by broker-dealers.

[11] The SEC notes that the proposed rescission of guidance regarding this requirement, which implicates the auditor's requirement to test the valuation assertion for all securities, does not impact the auditor's statutory requirement in Section 30(g) of the 1940 Act to verify securities owned, which implicates the auditor's requirement to test the existence assertion for all securities, and that Section 30(g) remains distinct from the requirements in auditing standards established by the PCOAB.

[12] The Proposing Release states that the letters and guidance that would be withdrawn or rescinded would include the following: *Paul Revere Investors, Inc.* (Feb. 21, 1973) (delegation to a board valuation committee); *The Putnam Growth Fund and Putnam International Equities Fund, Inc.* (Jan. 23, 1981) (fair value of portfolio securities which trade on a closed foreign exchange); *Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the Investment Company Act of 1940*, Rel. No. IC-15612, Appendix B, Guide 2 (Mar. 17, 1987) (fair value for UITs to be determined by the trustee or its appointed person); *Investment Company Institute* (Dec. 8, 1999 and Apr. 30, 2001) (fair value generally); and *Valuation Guidance Frequently Asked Questions* (FAQ 1 only) (2014) (fund directors' responsibilities when determining whether an evaluated price provided by a pricing service, or some other price, constitutes fair value).

[13] The SEC's valuation bibliography, provided on its website (the "Valuation Bibliography"), contains a comprehensive list of valuation guidance, including select relevant provisions of the 1940 Act and related rules, SEC releases and enforcement actions and other SEC and staff guidance. The Valuation Bibliography includes over 50 SEC releases in connection with enforcement proceedings dating as far back as 1943, a number of which are embedded with implicit SEC guidance regarding the actions (or inactions) of the charged parties. These releases are in addition to the dozens of other SEC releases (dating back as far as 1964) and other SEC and staff guidance listed in the Valuation Bibliography. *Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management*, available at: https://www.sec.gov/divisions/investment/icvaluation.htm.