

SEC Proposes New Fair Valuation Framework for Registered Funds

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Under the Investment Company Act of 1940 (the 1940 Act), securities held by a fund for which market quotations are readily available are to be priced at current market value, and securities for which market quotations are not readily available are to be priced at fair value as determined in good faith by the fund's board. On April 21, 2020, the Securities and Exchange Commission (SEC) proposed new Rule 2a-5 under the 1940 Act (the Proposed Rule), which is intended to provide a framework for fund valuation practices and to provide clarity on how fund boards can satisfy their statutory obligations in the valuation process.

I. Assignment of the Fair Value Determination

Under the Proposed Rule, a fund's board would be permitted to assign the responsibility to make fair value determinations for some or all fund investments to the fund's investment adviser or to one or more sub-advisers (collectively, advisers or individually, an adviser). Assignment to an adviser would trigger certain requirements, including the following:

- **Board Oversight and Adviser Reporting.** The fund's board would be required to oversee the adviser's performance of the fair value function, and the adviser would be required to make certain reports, as described below, on fair valuation to facilitate the board's oversight.
- **Quarterly Reporting.** The Proposed Rule would require the adviser, at least quarterly, to provide the board with a written assessment of the adequacy and effectiveness of the adviser's process for determining the fair value of the assigned portfolio of investments.
 - *General Requirement as to Adviser Reports.* The Proposed Rule would require the adviser's reports to include such information as may be reasonably necessary for the board to evaluate the matters covered in the reports. The content of the reports could include narrative summaries, graphical representations, statistical analyses, dashboards or exceptions-based reporting, among other reporting methods.
 - *Exceptions-Based Reporting Generally Is Sufficient.* A list of each individual fair-valued portfolio holding would not be required; exceptions-based or trend-oriented reporting, in the SEC's view, generally would provide a sufficient overview of the current state of the fair value process, subject to the minimum elements noted below.
 - *Minimum Requirements for Reports.* Quarterly reports would be required, at a minimum, to include a summary or description of the following information:
 - material valuation risks, including material conflicts of interest of the adviser or of any other service provider involved in the valuation function;
 - material changes to or material deviations from established methodologies;
 - results of testing of fair value methodologies;
 - the adequacy of resources for the fair value process, including any material changes to the roles or functions of the persons responsible for determining fair values;

- any material changes to the adviser’s process for overseeing pricing services, as well as any material events related to its oversight of those services, such as changes of service providers used or price overrides; and
 - any other materials requested by the board related to the adviser’s fair value determination process.
- **Prompt Board Reporting of Certain Issues.** The adviser would be required to make prompt (generally within three business days) written reports to the board on matters associated with the fair value process that materially affect, or could have materially affected, fair value determinations. Such matters would include 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.
 - *“Could have materially affected.”* Prompt board reporting would be required of matters that “could have materially affected” fair value determinations. The proposing release explains that this requirement is intended to capture circumstances in which, for example, a matter was detected that affected one security and that may not be material on its own, but, had the matter not been identified, could have materially affected the larger assigned portfolio of investments or some subset of that portfolio. Importantly, this is not intended to mandate reporting in circumstances in which, at the time a matter was detected, it did not seem that the matter would materially affect the fair value of the assigned portfolio but the matter later ended up having such an effect.
 - *Timing of Prompt Reports.* As proposed, the adviser would be required to provide these reports promptly, but in no event later than three business days after the adviser becomes aware of the matter, rather than waiting until the next quarterly report. In circumstances in which the materiality of a given event is in question, and the adviser needs some reasonable amount of time after becoming aware of the matter to verify and determine its materiality, the verification period would not be counted as part of the “prompt” trigger period. In the proposing release, the SEC stated that it believes this verification and final determination process should be completed within three business days or less, including the day that the adviser becomes aware of the triggering event. Consequently, any prompt report generally would have to be made no more than three business days after the adviser becomes aware of the event, but the adviser may, to the extent necessary, take limited additional time (but in no event more than three business days) for the verification and final determination process.
- **Specification of Functions.** The adviser would be required to clearly specify responsibilities and duties among advisory personnel involved in the fair value process, including reasonably segregating (but not necessarily eliminating) portfolio managers from the process.
 - *Reasonable Segregation from Portfolio Management.* The Proposed Rule would require the adviser to reasonably segregate the process of making fair value determinations from portfolio management. Strict protocols regarding communications between specific personnel (e.g., firewalls) would not be required; rather, advisers would tailor the segregation of functions to their facts and circumstances, taking into account the adviser’s size and resources.
 - *Use of Committees.* If the adviser uses a valuation committee or similar body to assist in the process of determining fair value, the fair value policies and procedures generally would describe the composition and role of the committee, or reference any related committee governance documents as appropriate.
- **Records of Assignment.** The fund would become subject to certain additional recordkeeping requirements. Specifically, a fund would be required to keep copies of the reports and other information provided to the board required by the Proposed Rule and a specified list of the investments or investment types whose fair value determinations have been assigned to the adviser pursuant to the requirements of the Proposed Rule. In each case, these records would be required to be kept for at least five years after the end of the fiscal year in which the documents were provided to the board or the investments or investment types were assigned to the adviser, the first two years in an easily accessible place.

- **Board Ratification of Fair Valuations Not Required.** The proposing release notes that the SEC considered, but did not include in the Proposed Rule, a requirement that boards periodically ratify the fair value determinations calculated by the adviser using the methodology determined by the board. The SEC determined that “such an approach would not allow funds the flexibility to leverage the fair value expertise of the investment adviser and assign a role to the fund’s board that is more in line with the board’s experience and expertise.”

II. Guidance to Fund Boards in the Proposing Release

The proposing release includes important guidance to fund directors regarding the SEC’s expectations for board oversight of the valuation process, including the following:

- **Skeptical and Objective Oversight.** Boards should approach their oversight of fair value determinations assigned to an adviser with a skeptical and objective view that takes account of the fund’s particular valuation risks, including with respect to conflicts of interest, the appropriateness of the fair value determination process and the skill and resources devoted to it.
- **Active Oversight.** The SEC stated that effective board oversight cannot be a passive activity. Directors should ask questions and seek relevant information. “The board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund’s fair value processes.”
- **Scrutiny of Subjective Inputs.** The SEC stated that it expects that boards would use the appropriate level of scrutiny based on the fund’s valuation risk, including the extent to which fair value determinations depend on subjective inputs. “As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, we expect that the board’s level of scrutiny would increase correspondingly.”
- **Management of Conflicts of Interest.** The SEC stated that it believes it is incumbent upon boards—consistent with their obligations under the 1940 Act and as fiduciaries—to seek to identify conflicts of interest, monitor such conflicts and take reasonable steps to manage such conflicts. “[T]he board should serve as a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values.” Therefore, boards are advised to critically review the information provided to them, particularly with regard to an adviser’s reporting on its own conflicts of interest.
- **Periodic Reviews of the Adviser’s Fair Value Processes.** The proposing release states that boards should probe the appropriateness of the adviser’s fair value processes, including the adequacy of resources supporting fair value functions, such as financial, technology, compliance and personnel resources and expertise, and the CCO’s oversight thereof, as well as the reasonableness of the adviser’s reliance on other service providers in this respect.
- **Nature of Board Reporting and Follow Up Expectations.** The proposing release advises boards to consider the type, content and frequency of the reports they receive and cautions that boards should be “fully informed of the adviser’s process for determining the fair value of fund investments.” Consequently, if the board becomes aware of material issues, the SEC believes that, in exercising its oversight duty, “the board must inquire about such matters and take reasonable steps to see that they are addressed.”

III. Determining Fair Value in Good Faith

The Proposed Rule would provide that determining fair value in good faith requires the performance by a fund’s board or adviser of certain functions, including:

- **Periodic Assessment of Valuation Risks.** To determine fair value in good faith, the Proposed Rule would require that the board or the adviser conduct a periodic assessment of any material risks associated with fair value determinations, including material conflicts of interest, and the management of those risks.
 - *Types and Sources of Valuation Risk.* The proposing release includes a non-exhaustive list of the types or sources of valuation risk, including:
 1. the types of investments held or intended to be held by the fund;
 2. potential market or sector shocks or dislocations;

3. the extent to which a fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;
4. the proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns;
5. reliance on service providers that have more limited expertise in relevant asset classes, the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which such third-party service providers rely on their own service providers (so-called "fourth party" risks); and
6. the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

However, other than material conflicts of interest, the SEC stated that it believes the specific valuation risks to be addressed under this requirement would depend on the facts and circumstances of a particular fund's investments.

- *Frequency of Assessments.* The Proposed Rule does not include a specific frequency for the required periodic assessment of a fund's valuation risks. The SEC stated that it believes different frequencies may be appropriate for different funds or risks, but significant changes in a fund's investment strategy, policies or investments, market events and other relevant factors should be taken into account.
- **Selection and Application of Fair Value Methodologies in a Consistent Manner.** The Proposed Rule would also require the selection and consistent application of appropriate fair value methodologies and the periodic assessment of those methodologies.
 - *Consistent Application of Methodologies.* Recognizing that different methodologies may be appropriate for different asset classes, the Proposed Rule would not require that a single methodology be applied in all cases, but instead that any methodologies selected be applied consistently to the asset classes for which they are relevant. However, this requirement would not preclude the board or adviser from changing the methodology for an investment in circumstances where an adjusted methodology would result in a measurement that is equally or more representative of fair value.
 - *Specificity of Methodologies.* Fair value methodologies would be required to identify the key inputs and assumptions specific to each asset class or portfolio holding.

For instance, the proposing release notes that it would not be sufficient to state simply that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional 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, but need not necessarily, take the form of a formula).

- *Consistency with ASC Topic 820.* To be appropriate under the Proposed Rule, and in accordance with current accounting standards, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820, and thus derived from the market approach, the income approach or the cost approach. In addition, the proposing release advises that, consistent with the principles in ASC Topic 820, the methodologies selected should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.
- *Identification of Methodologies for New Types of Investments.* The Proposed Rule also would require that the board or adviser consider the applicability of the selected fair value methodologies to types of investments that a fund does not currently hold but in which it intends to invest in the future. For example, the board or adviser, as applicable, generally should address, prior to the fund's investing in a new type of investment, whether readily available market quotations will be used or if the investment may need to be fair valued on occasion or at all times. As to the latter type of investments, the proposing release notes that the board or adviser generally should seek to identify sources of price inputs before the fund invests in such asset classes, if possible, in addition to determining an appropriate fair value methodology, and generally should document these decisions.
- *Periodic Review of Selected Methodologies.* The Proposed Rule would require that the board or the adviser conduct periodic reviews of the selected fair value methodologies for appropriateness and accuracy, and adjustments to the methodologies where necessary. (See "Testing Fair Value

Methodologies” below.)

- *Establishment of Criteria for Determining When Fair Value Is Needed.* The Proposed Rule would require the board or adviser to monitor for circumstances that may necessitate the use of fair value as determined in good faith, which is required when market quotations are not readily available. In this regard, the Proposed Rule would require the establishment of criteria for determining when market quotations no longer are reliable, and therefore are not readily available. (As discussed below, the SEC is also proposing to define when market quotations are “readily available” for purposes of the 1940 Act.)
- *SEC’s View Regarding the Potential Range of Appropriate Values.* Despite the prescriptive nature of the methodology requirements under the Proposed Rule, the proposing release states that the SEC “continue[s] to believe that for any particular investment there may be a range of appropriate values that could reasonably be considered to be fair value, and whether a specific value should be considered fair value will depend on the facts and circumstances of the particular investment.”
- **Testing Fair Value Methodologies.** The Proposed Rule would require that the board or the adviser perform periodic testing of the appropriateness and accuracy of fair value methodologies and make adjustments to methodologies where necessary. Specifically, the Proposed Rule would require the identification of (1) the testing methods to be used and (2) the minimum frequency of testing—elements that the SEC believes depend on the circumstances of each fund.
 - *Testing Methods Cited by the SEC.* Although the types of fair value testing methods to be implemented are left to the discretion of the board or adviser, as applicable, the SEC identifies calibration and back-testing as methods that “can be particularly useful in identifying trends, and also have the potential to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest.”
- **Oversight and Evaluation of Pricing Services.** Under the Proposed Rule, determining fair value in good faith would also include the oversight of any pricing services, including establishing both (1) a process for approving, monitoring and evaluating pricing services and (2) criteria for initiating price challenges.
 - *Factors to Consider in Evaluating Pricing Services.* The proposing release states that the board or adviser generally should take into consideration factors such as:
 - the qualifications, experience and history of the pricing service;
 - the valuation methods or techniques, inputs and assumptions used by the pricing service 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.
 - *Establishment of Criteria for Price Challenges.* The Proposed Rule would require the establishment of criteria for the circumstances under which price challenges typically would be initiated (e.g., establishing objective thresholds).
- **Fair Value Policies and Procedures.** Under the Proposed Rule, determining fair value in good faith would require the adoption and implementation of written policies and procedures to address fair value determinations that are reasonably designed to achieve compliance with the Proposed Rule’s requirements.
 - Where the board determines the fair value of investments, the board-approved fair value policies and procedures would be adopted and implemented by the fund.
 - Where the board assigns fair value determinations to the adviser under the Proposed Rule, the fair value policies and procedures would be adopted and implemented by the adviser, subject to board oversight pursuant to Rule 38a-1 under the 1940 Act (i.e., the fund compliance rule).
 - *Application of Rule 38a-1 to the Proposed Rule.* The proposing release states that Rule 38a-1 also would apply to a fund’s obligations with respect to the Proposed Rule, if adopted, and would require a fund’s board to oversee compliance with the rule. The proposing release notes that to the extent adviser policies and procedures under the Proposed Rule would otherwise be duplicative of fund valuation

policies under Rule 38a-1, a fund could adopt the Rule 2a-5 policies and procedures of the adviser in fulfilling its Rule 38a-1 obligations.

- **Recordkeeping.** The Proposed Rule would require funds to adequately document and retain certain records relating to fair value determinations. In this regard, the Proposed Rule would require the retention of appropriate documentation to support fair value determinations, including 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, for at least five years from the time the determination was made, the first two years in an easily accessible place. In addition, the Proposed Rule would require the retention of a copy of the policies and procedures required under the Proposed Rule that are in effect, or that were in effect at any time within the past five years, in an easily accessible place.

IV. “Readily Available” Market Quotations

Under the 1940 Act, a fair value determination must be made when a market quotation for an investment is not readily available. Under the Proposed Rule, a market quotation would be “readily available” only when the quotation is a quoted price (unadjusted) in active markets for identical investments that a fund can access at the measurement date. However, a quotation would not be considered readily available if it is unreliable, which would be the case if U.S. GAAP would require an adjustment to the quotation or the consideration of additional inputs to determine the value of the investment. In addition, the SEC’s proposing release states that evaluated prices, by themselves, as well as indications of interest and accommodation quotes, would not be readily available market quotations for purposes of the Proposed Rule.

V. Current SEC Guidance

As part of the proposal, the SEC would rescind two releases—Accounting Series Release 113, issued in 1969, and Accounting Series Release 118, issued in 1970—in which the SEC provided guidance on, among other things, the role of the fund board in fair value determinations as well as guidance on certain accounting and auditing matters. In addition, certain SEC staff letters and other staff guidance related to the fair value process would be withdrawn or rescinded in connection with any adoption of the proposal.

VI. Timing and the Comment Process

The SEC is proposing a one-year transition period to provide time for funds and their advisers to prepare to come into compliance with the Proposed Rule, if adopted.

Comments on the proposal should be submitted on or before July 21, 2020.

The proposing release is available [here](#).

If you have any questions regarding the U.S. Securities and Exchange Commission’s proposed new fair valuation framework for registered funds, please don’t hesitate to call **John S. Marten** at (312) 609 7753, **Jacob C. Tiedt** at (312) 609 7697, **Nate Segal** at (312) 609 7747, or any of the Vedder Price attorneys with whom you work.



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