

ALERTS

Regulated Funds: SEC Proposes New Fair Valuation Framework

June 3, 2020

On April 21, 2020, the SEC proposed a new rule under the Investment Company Act of 1940, as amended (“1940 Act”), addressing the valuation practices of registered investment companies and business development companies (“regulated funds”).^[1] Proposed Rule 2a-5 (“Proposed Rule”) represents an effort to modernize and codify a framework for fair value determination of regulated fund investments for registered investment companies. Most significantly, in a departure from prior SEC guidance and interpretation, and subject to several requirements and the continued oversight of the board, the Proposed Rule would allow a regulated fund’s board to assign the fair value determination of the regulated fund’s investments to the regulated fund’s investment adviser or sub-adviser, rather than requiring the board to make the final determination itself.

If adopted, the Proposed Rule could provide considerable benefit to regulated funds that invest from time-to-time in illiquid securities that do not have readily available market quotations, particularly when such illiquid investments represent a relatively small percentage of a regulated fund’s overall portfolio.^[2] With the assistance of investment advisers, boards of such regulated funds are currently required to engage in a time consuming and intensive process to make fair value determinations for these hard to value investments on a regular basis. Under the Proposed Rule, these boards would retain oversight of the valuation process, but could formally assign the fair value determination with respect to such illiquid assets, including the establishment and application of a fair value methodology, to the regulated fund’s investment adviser.

Conversely, however, a number of the requirements imposed under the Proposed Rule, including segregating the valuation process from the portfolio management function, may make reliance on the Proposed Rule by regulated funds that primarily invest in illiquid assets, such as business development companies (“BDCs”), less attractive or even impossible. In particular, BDCs and other similar illiquid-focused regulated funds tend to have well-developed procedures for boards to interact with both advisory personnel and third-party valuation firms, where appropriate, as part of the periodic valuation process. As a result, the boards of such regulated funds may be less willing to delegate their responsibilities with respect to, and therefore, potentially reduce their visibility and integral participation in, the valuation process. In addition, advisers to such regulated funds may be unwilling or unable to segregate portfolio management personnel from the valuation process, as would be required under the Proposed Rule.

In contrast, open-end regulated funds, including mutual regulated funds and exchange-traded regulated funds, may be more likely to take advantage of the flexibility afforded under the Proposed Rule, if adopted. Specifically, such open-end regulated funds would normally only have a small percentage of their respective portfolios invested in illiquid investments, if any. The ability to adopt detailed procedures to permit an open-end regulated fund’s board to delegate the valuation of such illiquid investments to the regulated fund’s adviser would, therefore, allow such regulated funds to more easily and efficiently handle assets that unexpectedly become illiquid, while also treating such investments in a manner that would be more consistent with how liquid investments are presently valued by most open-end regulated funds. In addition, the delegation of fair value determinations provided under the Proposed Rule would ease the burden of setting an open-end regulated fund’s net asset value, and therefore, the value of its investment portfolio, on a daily basis.

Although the Proposed Rule addresses regulated funds regulated under the 1940 Act, the Proposed Rule and the release proposing the rule (“Release”) may also provide insight into certain valuation-related matters with respect to investment advisers that advise private regulated funds, including relating to potential conflicts of interest in the valuation process. In addition, advisers that primarily advise private regulated funds but also advise or sub-advise regulated funds should familiarize themselves with the provisions of the Proposed Rule and may need to update their

valuation procedures to reflect certain requirements of the Proposed Rule.

Background

As discussed in the Release, the proper valuation of a regulated fund's investments plays a crucial role in various aspects of a regulated fund's operations, including the determination of a regulated fund's net asset value, which for many regulated funds determines the price at which a regulated fund's shares are offered and redeemed. Valuation of investments also affects the accuracy of a regulated fund's asset-based and performance-based fee calculations and impacts a regulated fund's ability to comply with its investment policies and restrictions. However, the SEC has not formally addressed regulated fund valuation practices since the early 1970s, when it issued Accounting Series Releases Nos. 113 and 118 ("ASRs") which still provide the basis for determination of fair value of securities today, along with guidance from the Financial Accounting Standards Board, particularly ASC Topic 820. The staff of the SEC also has provided guidance on valuation issues through a series of no-action letters.

Section 2(a)(41) of the 1940 Act defines "value" with respect to assets held by registered investment companies.^[3] The definition differentiates between assets for which market quotations are "readily available" and those for which market quotations are not readily available. When market quotations are not readily available, value is defined as fair value as determined in good faith by the regulated fund's board of directors.

The SEC notes in the Release that since the issuance of the ASRs, there have been significant changes in market and investment practices impacting regulated funds and the valuation of their investments, as well as several regulatory changes. Regulated funds now invest in more complex securities that present new valuation challenges. As an example, BDCs, which did not exist when the ASRs were issued, typically invest in the securities of small and middle-market companies that must be fair valued on at least a quarterly basis. The Release also notes that communications and technology advances have also resulted in greater availability of pricing information, as well as greater availability of other data that may be relevant in the valuation process.

The enactment of the Sarbanes-Oxley Act of 2002, which established the Public Company Accounting Oversight Board, the adoption of Rule 38a-1 under the 1940 Act requiring regulated funds to adopt compliance policies and procedures (including with respect to fair value) and the issuance of ASC Topic 820 by the Financial Accounting Standards Board all have significantly impacted the regulated fund valuation process. These regulatory developments, coupled with more complex and harder to value securities held by regulated funds, have resulted in boards relying more heavily on the expertise of investment advisers and third-party pricing services in an effort to effectively fulfill the fair value determination obligations set forth in Section 2(a)(41). The Release notes that while boards currently are responsible for determining the methodologies used to fair value regulated fund investments, they typically rely on the adviser and third-party pricing services for the day-to-day calculation of fair values.

Acknowledging the reality of current board practices and the developments discussed above, the Proposed Rule provides that the board may assign the fair valuation determination for investments to an investment adviser of the regulated fund (including a sub-adviser), subject to oversight of the board and certain reporting and recordkeeping requirements.^[4] It also provides a standardized framework for the actions and functions that are required in order to determine fair value in good faith. In addition, the Proposed Rule provides a definition of “readily available market quotation,” which is not otherwise defined in the 1940 Act or the rules thereunder.

Performance of Fair Value Determination

As noted above, the board of a regulated fund is responsible for determining in good faith the fair value for regulated fund investments for which market quotations are not readily available.^[5] The Release acknowledges that boards typically are not involved in the day-to-day valuation tasks that would be required to determine fair value and instead in practice often allocate this function to the regulated fund’s adviser, subject to the board’s supervision. In acknowledging this practical reality, the Proposed Rule would allow the board to assign the actual fair value determination to an investment adviser of the regulated fund, including sub-advisers, which would carry out the functions described in the above section, subject to the board’s oversight.

- *Oversight and Reporting.* The Release makes it clear that, even where a board has assigned fair value determination to the adviser, the board retains responsibility for oversight of the adviser. The Release notes that boards should approach this oversight with a “skeptical and objective view,” particularly with respect to potential conflicts of interest, and that oversight should be an active process. The Release encourages board members to seek out relevant information as may be necessary to be fully informed about the regulated fund's fair value process, with a goal of improving it. It also notes that the SEC expects that boards will utilize an appropriate “level of scrutiny” based on the regulated fund's valuation risk, and that this scrutiny should be proportionate to the level of subjectivity involved in determining fair value for an investment. The Release expects that boards will periodically review the financial resources, technology, staff, expertise and compliance capabilities of the adviser with respect to determination of fair value, with an aim to evaluate the appropriateness of the fair value process.

The Release also focuses on concerns relating to potential conflicts of interest that may arise as a result of the adviser or other service providers having incentives to improperly value regulated fund assets. It notes that a regulated fund's adviser may benefit from improper valuations, which could increase fees or improve returns.

Pursuant to the Proposed Rule, the adviser must provide to the board a written assessment of the adequacy and effectiveness of the adviser's fair valuation process, on at least a quarterly basis.[6] The adviser must also provide prompt reporting to the board (within three business days) on matters that could materially affect the fair value of investments. As noted in the Release, a board must also inquire about any material matters of which the board becomes aware, and take reasonable steps to ensure they are addressed.

- *Specify Responsibilities.* If fair value determination is assigned to an adviser, the adviser must specify the titles of the persons responsible for determining the fair value of the investment, and must reasonably segregate the process of making fair value determinations from the portfolio management of the regulated fund, in order to avoid potential conflicts of interest. Although the Release notes that portfolio managers may have relevant input into the process for determining fair value for investments, the inherent conflicts of interest that are present because portfolio management personnel are usually compensated

based on the returns of the regulated fund make it inappropriate for a portfolio manager to make the fair value determination.

- *Records When Assigning.* In addition to the recordkeeping requirements described above, when a board assigns fair value determination to the adviser, the regulated fund must also maintain copies of reports and other information provided to the board by the adviser, as well as a specified list of the investments (or investment types) whose fair value determination has been assigned to the adviser.

Fair Value Determination Under the Proposed Rule

In order to determine fair value in good faith of a regulated fund's investment, as required by Section 2(a)(41), the Proposed Rule lays out the following actions and functions that are required to be undertaken either by the board, or if the board has assigned fair value determination to the adviser, by the adviser.

- *Assess and Manage Valuation Risks.* The Proposed Rule requires the periodic assessment of material risks associated with valuation. The Release includes examples of the types and sources of such risks, including the types of investments held by a regulated fund, potential market or sector dislocations, the extent to which unobservable inputs are utilized in the valuation methodology and reliance on service providers and limitations of their experience. The Proposed Rule does not prescribe the specific valuation risks to be addressed, and instead requires that this assessment be based on the facts and circumstances of an individual regulated fund's investments. While a regulated fund's valuation risks should be re-assessed periodically, the Proposed Rule does not set a specific required frequency for assessment, which should instead depend on changes in regulated fund investments or in a regulated fund's strategy or policies, among other things.
- *Establish and Apply Fair Value Methodologies.* The Proposed Rule requires that an appropriate fair value methodology be selected and applied in a consistent manner to determine the fair value of investments.^[7] In this regard, the key inputs and assumptions specific to each asset class or portfolio holding held by the regulated fund, as well as which methodologies would apply to new types of regulated fund investments in which a regulated fund intends to invest, must be

specified. In addition, the appropriateness and accuracy of the selected methodologies must be reviewed periodically and adjusted as necessary. Under the Proposed Rule, circumstances necessitating the use of fair value would need to be monitored and criteria for determining when market quotations are no longer reliable would need to be put into place.

- *Test Fair Value Methodologies.* Once selected, the appropriateness and accuracy of the fair value methodologies must be tested, with the Proposed Rule requiring the identification of testing methods to be used and minimum frequency of testing. However, the Proposed Rule does not prescribe the specific testing methods or frequency of testing that should be undertaken, and instead such matters will depend on the facts and circumstances of each regulated fund, as determined by the board or the adviser. The Release notes that the results of calibration and back-testing can be particularly useful and can help identify issues with methodologies applied by regulated fund service providers.[8]
- *Evaluate Pricing Services.* The Release notes that, particularly with respect to more complex assets, regulated funds may rely on valuation information provided by third-party pricing services. The Proposed Rule requires the oversight and evaluation of such pricing services by the regulated fund's board or adviser, including the establishment of a process for the approval, monitoring and evaluation of each pricing service provider and setting criteria for initiating price "challenges" (i.e., where a regulated fund disagrees with a price provided by a pricing service).[9]
- *Fair Value Policies and Procedures.* The Proposed Rule requires that written policies and procedures that are reasonably designed to achieve compliance with the requirements described above be adopted and implemented to address the determination of the fair value of regulated fund investments. These policies and procedures are intended to help ensure that determination of fair value of regulated fund investments is accomplished in compliance with the Proposed Rule. Where the board has assigned fair value determinations to the investment adviser, the adviser must adopt and implement such procedures, which would be subject to board oversight pursuant to the requirements of Rule 38a-1 under the 1940 Act. The Release also notes that a regulated fund could adopt the Rule 2a-5 policies and procedures

of the adviser in order to fulfill its obligations under Rule 38a-1 to adopt compliance policies with respect to fair value.

- *Recordkeeping.* The Proposed Rule would require a regulated fund to maintain documentation supporting fair value determinations for at least five years from the time the determination was made (the first two years in an easily accessible place), as well as to maintain a copy of the regulated fund's fair value policies and procedures that are in effect, or that were in effect at any time in the past five years, in an easily accessible place.

Notably, many of the above actions and requirements have previously been implemented by illiquid-focused regulated funds, such as BDCs, which often utilize a committee of independent directors, either through the audit committee or a separate valuation committee, to oversee the regulated fund's valuation process. In many cases, this board committee is tasked with approving, among other things, the engagement of third-party pricing services and changes to a regulated fund's valuation policies and procedures. This group of independent directors also often previews with a regulated fund's adviser and any third-party pricing services proposed valuations of illiquid investments prior to board determination of fair value.

Other Provisions of the Proposed Rule

Readily Available Market Quotations

As discussed above, for purposes of determining value of an investment, Section 2(a)(41) of the 1940 Act differentiates between whether market quotations are "readily available" or not, but this term is not defined in the 1940 Act or the rules thereunder. The Proposed Rule would define a market quotation as being "readily available" for purposes of the 1940 Act only when the quotation is a quoted price (unadjusted) in active markets for identical investments that the regulated fund can access at the measurement date, provided that a quotation will not be considered to be readily available if it is not reliable. The Release notes that a quote would be considered unreliable under the Proposed Rule in circumstances where it would require adjustment under U.S. Generally Accepted Accounting Principles ("U.S. GAAP") or where U.S. GAAP would require consideration of additional inputs in determining the value of the security. If a market quotation is not available, a fair value methodology must be

utilized in valuing the investment, and such methodology must also be determined in accordance with U.S. GAAP.

Rescission of Prior Commission Releases and Withdrawal of No-Action Letters

As noted in the Release, the SEC recognizes that, in light of more recent accounting standards and pronouncements, previous SEC guidance, including ASR 113 and ASR 118, as well as certain no-action letters relating to valuation, are no longer necessary and are proposed to be rescinded or withdrawn.

Transition Period

In order to provide regulated funds and advisers with sufficient time to prepare for compliance with the Rule, the effective date of the Proposed Rule, if adopted, would be one year following the publication of the final rule in the Federal Register.

Impact of the Proposed Rule on Boards and Advisers

The Proposed Rule represents an effort to formalize a more realistic allocation of responsibility for fair value determination as between a regulated fund's board and its adviser. The rule has the potential to significantly streamline the fair value process for certain regulated funds that may only hold illiquid investments on an infrequent basis, and may aid open-end regulated funds in better handling their determination of daily net asset value when they hold one or more illiquid investments from time to time. However, as the Proposed Rule and the Release make clear, a board that assigns fair value determination to the adviser still retains substantial responsibility to oversee and assess the valuation process. In addition, the Proposed Rule requires a delineation between the valuation and portfolio management functions at the adviser level if a board opts to delegate fair value determinations in accordance with the Proposed Rule. As a result, BDCs and other regulated funds that invest primarily in illiquid assets may be less likely to take advantage of the delegation of fair value determinations afforded under the Proposed Rule, particularly in view of the robust board procedures such regulated funds typically already have in place to handle quarterly valuations.

The Proposed Rule also prescribes the information that must be reported by an adviser to a board in the case of assignment, including relating to any material conflicts of interest an adviser (or other service provider) may encounter in the valuation process and to the adequacy of the resources allocated to the valuation process. In addition, the Proposed Rule sets out specific responsibilities of boards and advisers with respect to oversight and evaluation of pricing services. Therefore, while the Proposed Rule should help to improve the overall valuation process, it may require boards and advisers to make changes to their current valuation processes to meet the functions and requirements specified in the rule. In addition, the Proposed Rule will eliminate certain flexibility with respect to valuation that regulated funds and boards currently enjoy, given the significant number of requirements in the rule.

Potential Impact on Advisers

While the Proposed Rule applies only to regulated funds regulated under the 1940 Act, there are certain elements of the rule and the Release that could be viewed as best practices for all advisers to consider adopting, particularly with respect to potential conflicts of interest in the valuation process. As the Release notes, to the extent a regulated fund's board delegates fair value determinations to a regulated fund's adviser, it is important that the adviser's fair value determination function be segregated from the portfolio management of that regulated fund to the extent possible, in order to avoid potential conflicts of interest. Investment advisers may find it challenging to separate their portfolio management personnel from those making fair value determinations, not only from a resources perspective but also in view of the detailed knowledge a regulated fund's portfolio manager likely has with respect to the illiquid investments a regulated fund holds. The definition of readily available market quotations contained in the Proposed Rule can also provide additional clarity to advisers of private regulated funds, and the requirement to evaluate and monitor pricing services in the Proposed Rule provides a reminder to all advisers of the importance of doing so.

It is also very important for an adviser to be able to demonstrate that its valuation process was robust, and to address as many sources of data as possible (and, of course, to retain robust, contemporaneous records of the valuation effort).

Next Steps

The Release contains numerous questions posed at regulated funds and their boards and advisers contending with the challenges of valuation. Regulated funds and their boards and advisers should consider whether the Proposed Rule provides a useful framework to formalize current valuation practices, in light of the requirements imposed by the rule. The public comment period for the proposal will remain open until July 21, 2020.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] Investment Company Act Release No. 33845 (April 21, 2020), available [here](#).

[2] These investments typically are valued using inputs categorized within Level 3 of the fair value hierarchy established by the Financial Accounting Standards Board in ASC Topic 820.

[3] Section 59 makes Section 2(a)(41) applicable to BDCs.

[4] Unit investment trusts, which do not have a board of directors, could assign the fair value determination to the trust's trustee under the Proposed Rule.

[5] See Section 2(a)(41)(B)(ii) of the 1940 Act. In ASR 118, the SEC acknowledged that the board may appoint a person to assist with the determination of fair value, but the findings must still be reviewed carefully by the board.

[6] These reports must include a summary of, among other things, material valuation risks, including any material conflicts of interest of the investment adviser or other service providers, material changes to or material deviations from methodologies, testing results, adequacy of resources, material changes to the adviser's process for overseeing pricing services and any other information requested by the board.

[7] The Release notes that in order to be appropriate under the rule, a methodology must also be consistent with ASC Topic 820, which covers various valuation approaches and techniques, and should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

[8] Calibration refers to the process of monitoring for material differences between the price paid for a fair valued holding as compared to the price calculated for such holding at the time of acquisition by the regulated fund's fair value methodology. Back-testing compares the fair value of a regulated fund's investment to observed transaction or other market information, including quotes from dealers or pricing services data.

[9] The Release notes certain factors that should be considered in such an oversight process, including, among other things (i) the qualifications, experience and history of the pricing service, (ii) the valuation methods or techniques used by the pricing service for different asset classes, (iii) the process for considering price challenges, (iv) potential conflicts of interest of the pricing service and (v) the testing processes used by the pricing service.

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