

SEC Proposes Regulations for Determining Fair Value of Securities Held by Investment Companies

The Securities and Exchange Commission (Commission) delivered its [long-promised and needed update](#) to guidance on determining the fair value of securities under the Investment Company Act of 1940 (1940 Act) on April 21, 2020. The update comes in the form of a proposed regulation, rather than guidance. [Release No. IC-33845](#) (release). Section 2(a)(41) of the 1940 Act and [Rule 2a-4](#) thereunder require "securities with respect to which market quotations are readily available [to] be valued at current market value, and other securities ... [to] be valued at fair value as determined in good faith by the board of directors."

The good news is that proposed Rule 2a-5 would largely conform to many funds' current practices. The better news is that the Commission proposes to use its authority under Section 6(c) of the 1940 Act to officially permit an investment company's board of directors or trustees (board) to assign responsibility for determining fair values to the company's investment adviser. This update reviews the most significant aspects of newly-proposed Rule 2a-5.

Overview of Proposed Rule

Required Procedures. Rule 2a-5 would apply to all investment companies and business development companies registered under the 1940 Act (funds). Paragraph (a) of the rule would require written policies and procedures (Valuation Procedures) addressing the following:

- Assessment and management of valuation risks
- Selection and application of fair value methodologies
- Testing of such methodologies
- Oversight of pricing service providers

Delegation and Oversight. Paragraph (b) of Rule 2a-5 would permit a board to assign responsibility for determining the fair value of investments to any investment adviser or sub-adviser to a fund (Adviser). The board may assign responsibility for all such determinations to one Adviser or, if the fund has multiple sub-Advisers, may allocate to each Adviser responsibility for determining the fair value of its investment portfolio. The board may retain responsibility for determining fair values in limited circumstances or if it elects not to assign responsibility to the Adviser. Rule 2a-5 would define a "board" to include a "designated committee ... composed of a majority of directors who are not interested persons of the Fund" as defined in the 1940 Act (Board Valuation Committee or BVC).[1]

Advisers assigned responsibility for determining fair values would be required to adopt and implement the Valuation Procedures. An Adviser's Valuation Procedures must specify the titles and functions of the persons responsible for determining fair values and reasonably segregate a fund's fair valuation process from its portfolio management. The board or BVC must oversee the Adviser's performance of the assigned responsibilities, which the Adviser would facilitate by providing quarterly reports about the adequacy and effectiveness of the Valuation Procedures. The Adviser must also promptly report matters that materially affect the fair value of assigned investment portfolio.

If a board or its BVC retains responsibility for determining fair values, the fund must adopt and implement the Valuation Procedures. The Valuation Procedures, whether adopted by an Adviser or a fund, must provide for retention of various records relating to implementation of the procedures and board reports for a period of five years, the first two in an easily accessible place.

When Fair Value Must Be Determined. Paragraph (c) would define when market quotations are "readily available" for an investment, specifically:

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.

Apart from the proviso as to reliability, this definition would be identical to the definition of Level 1 inputs in FASB Accounting Standard Codification Topic 820: *Fair Value Measurement* (ASC Topic 820).[2]

Oddly, Rule 2a-5 would define "fair value" in the negative as whatever value is determined when market quotations are **not** readily available for an investment. The release, however, adopts ASC Topic 820's definition of "fair value as the price that would be received to sell an asset ... between market participants at the measurement date under current market conditions (an exit price)." [Release at 63 n.147](#).

Some Observations

Our initial thoughts on proposed Rule 2a-5, based on the assumption that a board will assign responsibility to determine fair values to an Adviser, are as follows.

1. Valuation Risks. The first requirement of the Valuation Procedures would be to assess and manage "material risks associated with the determination of the fair value of fund investments ('valuation risks')." Rule 2a-5 would expressly include "material conflicts of interest of the investment adviser (and any other service provider)" as valuation risks. In addition to the risk of failing to identify when market quotations are not readily available, the release provides the following "non-exhaustive list of the types or sources of valuation risk":

- The types of investments the fund holds or intends to hold
- Potential market or sector shocks or dislocations
- The extent to which a fair value methodology uses unobservable inputs, particularly if the Adviser provides the inputs
- The proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns
- Reliance on service providers with 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 third party service providers rely on their own service providers
- The risk that the fund may use an inappropriate methodology for determining fair value or the methodology is applied inconsistently or incorrectly

[Release at 17-18](#). The release does not elaborate on the implications of the "portion of investments that are fair valued;" does this suggest that the portion could be so small as to not pose a significant valuation risk? Could a fund without significant valuation risks use less onerous methods to determine the fair value of these few investments?

2. Conflicts of Interest. The Adviser's potential conflicts of interest figure prominently in the release's discussion of valuation risks and appropriate Valuation Procedures. The potential for conflicts seems

unavoidable, as bonuses and other incentives intended to encourage portfolio management teams to out-perform their benchmarks and competitors (which is in the interest of the fund's shareholders) can also create a bias in favor of higher valuations. Nevertheless, the process for determining fair values must rely heavily on the input of the portfolio management team, as no one else at the Adviser generally will have as much knowledge of the relevant market conditions and other material factors underlying an investment's fair value. Even when a fund uses independent pricing services, the Adviser typically relies on the portfolio management team to vet the service's methodology, and then monitor and challenge the resulting fair values.

The requirement of Rule 2a-5 that an Adviser's Valuation Procedures "reasonably segregate the process of making fair value determinations from the portfolio management of the fund" is intended as one means of addressing these potential conflicts. The release suggests "independent reporting chains, oversight arrangements, or separate monitoring systems and personnel," as possible means of segregation. This would be consistent with the structure of many funds' current valuation committees, which are frequently composed of representatives from fund treasury, risk management, administration, and compliance in addition to investment personnel.

3. Board Oversight. The Commission also expects the board's or BVC's oversight to "serve as a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values." [Release at 36](#). The Adviser's quarterly reports are intended to provide the board or BVC with sufficient information to perform its oversight responsibilities, including information regarding the following:

- The management of valuation risks
- Any material changes to, or deviations from, fair value methodologies
- Testing results
- Material changes in the roles, functions, or processes of those responsible for determining fair values
- The adequacy of resources available for determining fair values

The Commission encourages directors and trustees to—

approach their oversight of fair value determinations ... with a skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it.

[Release at 34-35](#). Another important aspect of effective oversight and the informed exercise of business judgment by the board or BVC is development of a candid and supportive relationship with whomever is principally responsible for implementing the Valuation Procedures. This may bring valuation issues to light early, when they may be remediated without substantial repercussions.

4. Reporting Material Matters. In addition to quarterly reports, proposed Rule 2a-5 would require an Adviser to "promptly" report "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." An Adviser could take up to three business days to verify and determine a matter's materiality before making this report. [Release at 50](#).

We are unsure what "matters" would need to be reported "promptly." The rule would include, as examples, "a significant deficiency or material weakness in the design or implementation of the [Valuation Procedures] or material changes in the fund's valuation risks." The release adds "a significant increase in price challenges or overrides [that] would reflect a material change to the fund's valuation risks" as another example. [Release at 49 n.113](#). We can understand how frequent challenges and overrides might be "associated with the adviser's process," but changes in valuation risks due to other factors (such as "market or sector shocks or dislocations") may not be. Would all material changes in valuation risks need to be reported promptly, or only those with procedural implications?

It is also unclear how materiality should be gauged. The release refers to "a matter . . . , which affected one security and which 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*" as something to be reported promptly. *Id.* (added emphasis). This suggests that materiality would be based on more than the fair value of an individual investment, but how much more is unclear.

The Commission may be struggling with this as well; the release makes nine requests for comment on this proposed requirement, most of which include multiple questions.

5. Guidance. Rule 2a-5 would go into effect one year after its final adoption. On that date, the Commission would also withdraw prior guidance concerning fair value determinations, including Accounting Series Release Nos. 113 and 118 and various no-action letters. [Release at 66-67.](#)

The release makes over two dozen references to ASC Topic 820 and states that "the measurement concepts under ASC Topic 820 are consistent with the [1940] Act and the Commission's prior statements." This may open the door to allowing boards, BVCs, and advisers to refer to the extensive guidance on valuation found in accounting literature.

Conclusion

We expect that trustees, directors, and advisers will find proposed Rule 2a-5 an improvement over the antiquated guidance provided primarily by the Commission's staff. We also expect that further scrutiny of the proposal will yield opportunities for clarification or improvement. Boards and Advisers should not miss the opportunity to comment on this important proposal. Comments are due by July 21, 2020.

Endnotes

[1] To avoid confusion, "board" as used in this update refers to the full board and not to a BVC.

[2] KPMG provides a helpful FAQ on Fair Value Measurement under US GAAP and IFRS which may be found at <https://assets.kpmg/content/dam/kpmg/xx/pdf/2017/12/fair-value-qa-2017.pdf>.

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