# SEC Rule Proposal: Good Faith Determinations of Fair Value Under the Investment Company Act

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# SEC Rule Proposal: Good Faith Determinations of Fair Value Under the Investment Company Act

The U.S. Securities and Exchange Commission on April 21, 2020 proposed a long-anticipated framework for fair valuation of fund investments.[1] Proposed Rule 2a-5 under the Investment Company Act of 1940 would establish requirements for good faith determinations of fair value and would address roles and responsibilities for both fund boards and fund advisers relating to fair valuation.

The concept of "fair value" is embedded in the Investment Company Act definition of the "value" of a fund's assets – the value of securities for which market quotations are not readily available is defined as fair value as determined in good faith by the fund's board of directors.[2] Recognizing the evolution of markets and fund investment practices since the SEC's issuance of its most recent comprehensive treatment of fund valuation,[3] as well as three significant regulatory developments since that time,[4] the SEC seeks to modernize and formalize the framework for fair valuation determinations under the Investment Company Act.

## Executive Summary

Proposed Rule 2a-5 would create a risk-based fair valuation regime focused on process, testing and oversight. The proposed rule would:

- Set forth detailed requirements for determining fair value in good faith;
- Establish the conditions under which a market quotation is readily available for purposes of the Investment Company Act definition of "value"; and
- Provide that a fund board may assign its fair value determination responsibilities to a fund adviser subject to a number of conditions.

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1 *See* Good Faith Determinations of Fair Value, SEC Rel. No. IC-33845 (April 21, 2020) (Release). Unless otherwise specified, the term "fund" as used herein refers to a registered investment company or business development company (BDC). *See* proposed Rule 2a-5(e)(1).

2 *See* Investment Company Act Section 2(a)(41)(A), (B); *see also* Release at 5 ("The Investment Company Act requires funds to value their portfolio investments using the market value of their portfolio securities when market quotations for those securities are 'readily available,' and, when a market quotation for a portfolio security is not readily available, by using the fair value of that security, as determined in good faith by the fund's board."). Investment Company Act Section 59 makes Section 2(a)(41) applicable to BDCs. Release at 8 n.11.

3 The Release notes that the SEC "last comprehensively addressed valuation under the Investment Company Act in a pair of releases issued in 1969 and 1970, Accounting Series Release 113 (ASR 113) and Accounting Series Release 118 (ASR 118)." Release at 8; *see also* Statement Regarding "Restricted Securities," Accounting Series Release No. 113 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970).

4 These developments were the: (i) enactment of the Sarbanes-Oxley Act of 2002, the adoption of certain rules mandated thereby, and the establishment by such act of the Public Company Accounting Oversight Board; (ii) adoption of Rule 38a-1 under the Investment Company Act and Rule 206(4)-6 under the Investment Advisers Act of 1940; and (iii) issuance and codification by the Financial Accounting Standards Board of Accounting Standard Codification Topic 820 (ASC Topic 820). Release at 10-14.

Under proposed Rule 2a-5, determining fair value in good faith would involve satisfying six requirements:

- Periodic assessment of material risks associated with determining fair value of fund investments (valuation risks);
- Establishment and application of fair valuation methodologies, consistent with current accounting guidance for fair valuation and taking into account the fund's valuation risks;
- Testing of fair valuation methodologies;
- Evaluation of pricing services, if used;
- Adoption and implementation of written policies and procedures reasonably designed to achieve compliance with the four preceding requirements; and
- Maintenance of specified records.

Proposed Rule 2a-5 would further specify that the establishment and application of fair valuation methodologies (requirement (ii) above) involves:

- Selecting and consistently applying methodologies for determining and calculating fair value, including specifying key inputs and assumptions specific to each asset class or portfolio holding and the methodologies that will apply to new types of fund investments in which a fund intends to invest;
- Periodically reviewing the appropriateness and accuracy of selected methodologies and making necessary adjustments;
- Monitoring for circumstances requiring fair valuation; and
- Establishing criteria for determining when market quotations are no longer reliable.

Proposed Rule 2a-5 also would provide that, for purposes of Section 2(a)(41) of the Investment Company Act, 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. Proposed Rule 2a-5 would specify that a quotation is not readily available if it is not reliable.

Proposed Rule 2a-5 states that a fund's board must determine fair value in good faith by carrying out the required functions noted above. The proposed rule would, however, permit the board to assign that responsibility to an investment adviser of the fund (which could include one or more sub-advisers). An investment adviser assigned fair valuation responsibilities would carry out those responsibilities subject to certain additional conditions:

- Periodic reporting and written assessment of the fair valuation process's adequacy and effectiveness;
- Prompt written reporting of matters associated with the fair valuation process that materially affect, or could have materially affected, the fair value of portfolio investments;
- Reasonable segregation of the fair valuation determination process from portfolio management; and

- Maintenance of certain additional records.

In the Release, the SEC articulated certain high-level expectations regarding board oversight where the board assigns fair valuation responsibilities to an adviser: boards should be objective and approach this oversight with a skeptical view; effective oversight is not passive but rather involves continuous engagement; and boards should consider this oversight to be an iterative process of identifying issues and opportunities for improvement.

While the possibility of a more modern valuation framework and harmonization with accounting standards may be welcome to fund boards and advisers, it is important for industry participants to evaluate the proposal in light of current practices and to provide feedback to the SEC as part of the comment process. As a practical matter, the proposed rule could place prescriptive responsibilities on a fund's board that are more burdensome than current practices, and also could require the adoption of more detailed valuation policies and procedures and retention of more specific records than is required currently. In addition, the proposed rule's definition of "readily available market quotations" may reflect a narrower definition than the one used in practice by many funds (particularly with respect to fixed income securities) and have unintended consequences under other provisions of the Investment Company Act and rules thereunder that incorporate this concept.

The requirements of proposed Rule 2a-5, together with certain related considerations, are discussed in more detail below.

## Background

Valuation represents a critical responsibility of a fund because the proper valuation of a fund's portfolio securities is necessary for the calculation of the fund's current net asset value (NAV) per share. Because the Investment Company Act requires that open-end funds offer and redeem their securities at a price based on the fund's current NAV,[5] improperly determined valuations may cause adverse consequences (*e.g.,* dilution of fund shares, creation of arbitrage opportunities, and improper computation of asset-based fees). Proper valuation of portfolio securities allows all transacting fund shareholders to pay or receive a price that represents their proportionate share of the fund's portfolio. The concept of valuation also is embedded in many other provisions of the Investment Company Act, such as the Section 18 limitations on leverage, Section 5 diversification requirements, and the industry concentration rules.

Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder require valuation of a portfolio security at its "current market value" if market quotations for the security are "readily available." Portfolio securities for which market quotations are not readily available must be valued at fair value as determined in good faith by the board of directors.

To provide guidance as to this requirement, the SEC issued a pair of releases – ASR 113[6] in 1969 and ASR 118[7] in 1970 – that addressed a variety of topics related to the valuation of fund portfolio securities. Importantly, ASR 113 and

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[5] Rule 22c-1(a) under the Investment Company Act requires that an open-end fund generally must sell and redeem its shares at a price based on the fund's current NAV as next computed after the receipt of a redemption, purchase or sale order.

[6] In relevant part, ASR 113: (i) provides conceptual definitions of the key terms "readily available market quotations" and "fair value"; (ii) rejects any determination of fair value by an "automatic formula"; and (iii) confirms that fund boards can approve a fair valuation methodology while delegating calculations to other "persons" acting pursuant to the board's direction, as long as the board "continuously" reviews the method chosen. It also requires that a fund board consider all relevant factors, including the operations of the issuer, changes in general market conditions, and the extent to which the inherent value of the securities may have changed. Further, ASR 113 defines "restricted security" and "current sale" and applies a current sale test to fair value restricted securities.

[7] In relevant part, ASR 118 addresses valuation of securities listed or traded on a national securities exchange and securities that are traded in the OTC market, including the use of the last quoted sale price, published closing bid and asked prices and broker quotes. Specifically, it states that value can be determined fairly in more than one way for unlisted securities traded regularly in

ASR 118 acknowledged certain practical realities associated with the fair valuation process. First, the SEC acknowledged that "the board need not itself perform each of the specific tasks required to calculate fair value in order to satisfy" its Section 2(a)(41) obligation.[8] However, the board must "choose the methods" for determining fair value and "continuously review[] the appropriateness of such methods." [9] Second, the SEC stated that "[n]o single standard for determining 'fair value … in good faith' can be laid down, since fair value depends upon the circumstances of each individual case." [10]

Subsequent to the issuance of ASR 113 and ASR 118, the SEC and its staff provided further guidance on fund valuation matters, most notably in a pair of letters from the SEC staff to the Investment Company Institute in 1999[11] and 2001.[12] Among other topics, the letters provide further guidance regarding a board's "good faith" responsibilities, particularly in light of emergency or unusual situations, and discuss the requirement to monitor for significant events that could impact the valuation of a fund's investments. The 2001 Letter indicates that a fund investing in a foreign security "must evaluate whether a significant event (*i.e.*, an event that will affect the value of a portfolio security) has occurred after the foreign exchange or market has closed, but before the fund's NAV calculation."[13] If so, the security's closing price is not a "readily available" market quotation, and the security must be fair valued.[14]

The Release notes that there have been a number of regulatory developments that "fundamentally altered" how funds and fund boards address fair valuation since ASR 113 and ASR 118 were issued. First, the Sarbanes-Oxley Act of 2002 and the adoption of rules mandated thereby resulted in the establishment of the Public Company Accounting Oversight Board, which in turn "has the authority to establish or adopt, among other things, professional standards, including audit and quality controls standards, to be used by registered public accounting firms in the preparation and issuance of audit reports."[15]

Second, in 2003, the SEC adopted rules requiring investment advisers and registered investment companies to adopt compliance programs,[16] including policies and procedures with respect to fair valuation, and to designate a chief

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the OTC market, because fair value depends on the facts and circumstances of each situation. It also interprets "fair value" to mean the amount that a fund might "reasonably expect to receive for [a] security upon [its] current sale." The Financial Accounting Standards Board (FASB) has provided similar guidance. According to FASB, fair value is "the price that would be received [for the security] … in an orderly transaction between market participants at the measurement date." FASB ASC Topic 820, Fair Value Measurements (Jan. 2010).

8 Release at 9.

9 *Id.*

10 ASR 118.

11 Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC (Dec. 8, 1999) (1999 Letter).

12 Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC (Apr. 30, 2001) (2001 Letter).

13 2001 Letter.

14 *Id.* The 2001 Letter describes how short-term investors could seek to take advantage of funds that do not account for such significant events when calculating NAV. Subsequently, as part of form amendments adopted following the market timing scandals, the SEC adopted a requirement for funds to disclose the circumstances under which fair value pricing will be used and the effects of such use. *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, SEC Rel. No. IC-26418 (April 19, 2004).

15 Release at 10-14.

16 *See supra* note 4.

compliance officer (CCO) to administer them. Further, in 2006, FASB issued Statement of Financial Accounting Standards No. 157 (now codified as Accounting Standard Codification Topic 820 (ASC Topic 820)), which "defines the term 'fair value' for purposes of the accounting standards and establishes a framework for the recognition, measurement, and disclosure of fair value under" U.S. generally-accepted accounting principles (GAAP), as reflected in fund financial statements. In general, ASC Topic 820 requires consideration of the exit price, which is the price that would be received in a hypothetical transaction in an orderly market. ASC Topic 820 uses "fair value" "to refer generally to the value of an asset or liability, regardless of whether that value is based on readily available market quotations or on other inputs"[17] and identifies three levels of inputs for pricing securities.[18]

The Release states that the SEC is proposing Rule 2a-5 to "reflect the increased role [these] subsequent accounting and auditing developments play in setting fund fair value practices, as well as the growing complexity of valuation and the interplay of the compliance rule in facilitating board oversight of funds."[19]

## Fair Value Determination

Proposed Rule 2a-5 seeks to establish a "minimum, consistent framework" and a "standard of baseline practices across funds"[20] for fair value determinations under Section 2(a)(41) through satisfaction of the conditions listed below. The proposed rule would prescriptively define what constitutes "fair value in good faith" and thus compliance with all of these requirements would be necessary for a board to meet its statutory obligation to determine fair value in good faith:

- Periodic assessment of material valuation risks;
- Establishment and application of fair valuation methodologies, taking into account the fund's valuation risks;
- Testing of fair valuation methodologies;
- Evaluation of pricing services, if used;
- Adoption and implementation of written policies and procedures reasonably designed to achieve compliance with the four preceding requirements; and
- Maintenance of certain specified records.

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[17] Release at 8 n.13.

[18] Under ASC 820, the preferred valuation is based on a "Level 1" input (essentially a quoted price in active markets for identical securities), unless there is a significant event between the market close and measurement date. "Level 2" inputs are other significant observable inputs (including quoted prices for similar securities, interest rates, prepayment spreads, credit risks). "Level 3" inputs are significant unobservable inputs (including a fund's own assumptions used to determine the fair value of investments).

[19] Release at 14.

[20] Release at 14-15. This language echoes discussion in the liquidity rule adopting release, where the SEC noted that observations on fund liquidity risk management practices gathered through staff outreach "informed [the SEC's] understanding of the need for an enhanced minimum baseline requirement for fund management of liquidity risk." *See* Investment Company Liquidity Risk Management Programs, SEC Rel. No. IC-32315 (Oct. 13, 2016) (Liquidity Rule Adopting Release).

### *Condition 1: Periodic Assessment of Material Valuation Risks*

The first proposed requirement for determining fair value in good faith is periodic assessment of material valuation risks (including material conflicts of interest) and management of such risks. Except for material conflicts of interest, the proposed rule does not specify particular valuation risks that must be assessed and managed, but the SEC noted that types and sources of valuation risk are fact-dependent and may include, without limitation:

- Types of investments held or intended to be held;
- Potential market or sector shocks or dislocations (which may be indicated by, for example, significant changes in short-term volatility, liquidity, or trading volume, or sudden increases in trading suspensions);
- The extent to which unobservable inputs are used in a fair valuation methodology, especially adviser-provided inputs;
- The proportion of fund investments that are fair valued and their contribution to fund returns;
- The use of service providers, including reliance on service providers with limited experience in relevant asset classes, the use of fair value methodologies that rely on third party-provided inputs, and the extent to which service providers rely on other service providers; and
- The use of inappropriate fair valuation methodologies or the inconsistent or incorrect application of fair valuation methodologies.[21]

Among advisers' potential conflicts of interest, the Release lists incentives to: inflate asset values (or deflate liability values) resulting from asset-based management fees; smooth fund performance to lower the fund's perceived risk; and expend less effort than required.[22]

A fund's periodic reassessment of valuation risks should take into account (among other "relevant factors"): changes in investments; significant changes in strategy or policies; and market events. No specific reassessment frequency is proposed.[23]

In addition to requesting comments on whether the proposed requirement to assess material valuation risks is appropriate, the Release asks whether the SEC should: define the specific risks to be considered or provide guidance; and specify a reassessment frequency or the types of events and changes that should prompt a reassessment.

### *Condition 2: Establishment and Application of Fair Valuation Methodologies*

Determining fair value in good faith under the proposed rule also would require:

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21 Release at 17-18. The SEC also noted that valuation risk includes risks associated with determining whether an investment must be fair valued. *Id.* at n.41.

22 Release at 87-88.

23 Release at 18.

- Selecting and consistently applying appropriate methodologies[24] for determining and calculating fair value, including specifying: (i) key inputs and assumptions specific to each asset class or portfolio holding; and (ii) which methodologies apply to new types of fund investments in which a fund intends to invest;
- Periodically reviewing the appropriateness and accuracy of selected methodologies and making necessary adjustments;
- Monitoring for circumstances requiring fair valuation; and
- Establishing criteria for determining when market quotations are no longer reliable.

Appropriate Methodologies: Consistency with ASC Topic 820

In order for a fair valuation methodology to be appropriate under the proposed rule, it "must be consistent with ASC Topic 820, and thus derived from one of" the valuation approaches referred to in ASC Topic 820 (*e.g.*, the market approach, income approach or cost approach). Moreover, "[c]onsistent 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."[25]

Consistent Application of Methodologies

Although the proposed rule would not require that a single fair valuation methodology be used in all cases, the SEC noted that "any methodologies selected [must] be applied consistently to the asset classes for which they are relevant."[26] The SEC clarified that this proposed requirement would not preclude changing the fair valuation methodology for an investment where an adjustment "would result in a measurement that is equally or more representative of fair value" consistent with the guidance in ASC 820.[27] However, it is not clear how this requirement incorporates, if at all, earlier statements by the SEC staff indicating that a board could take into "the nature of the particular fund" and "the context in which the board must fair value price" in satisfying its good faith obligation under Section 2(a)(41).[28]

Key Inputs and Assumptions

Under the proposed rule, selecting and consistently applying appropriate fair valuation methodologies would include specifying key inputs and assumptions specific to each asset class or portfolio holding. The SEC elaborated that this requirement would involve providing 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)."[29] Significantly, the SEC explained that merely stating

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24 The SEC noted that while ASC Topic 820 "refers to valuation approaches and valuation techniques," many valuation techniques are in practice referred to as "methods." Accordingly, the Release "uses the terms 'technique' and 'method' interchangeably" and similarly "uses the terms 'methods' and methodologies' interchangeably." Release at 19 n.44.

25 Release at 20 n.48.

26 Release at 20 n.46.

27 Release at 21.

28 *See* 1999 Letter.

29 Release at 19 n.45.

that particular types of investments are valued using a particular method (such as stating that options are valued using a Black-Scholes model), without more, would be insufficient under the proposed rule.[30]

Methodologies for New Types of Investments

Under the proposed rule, selecting and consistently applying appropriate fair valuation methodologies also would include specifying which methodologies apply to new types of investments for a fund. This proposed requirement would involve, before investing in a new type of investment: (i) addressing whether readily available market quotations will be used or if fair valuation may be necessary in some or all cases; (ii) seeking to identify sources of price inputs; and (iii) documenting these decisions.[31]

Periodic Reviews and Adjustments

The SEC explained that the results of fair valuation method testing (such as back-testing or calibration, discussed in more detail below) or changed circumstances could result in an adjustment to a fair valuation method. The SEC cited ASC Topic 820's "non-exhaustive list of events that may warrant a change or an adjustment to a valuation technique": (i) new markets develop; (ii) new information becomes available; (iii) information previously used is no longer available; (iv) the valuation technique improves; and (v) market conditions change.[32]

Monitoring for Circumstances Requiring Fair Valuation; Establishing Criteria for Determining When Market Quotations are No Longer Reliable

As discussed above, under the Investment Company Act's definition of "value," fair valuation is required when market quotations are not readily available. The proposed rule would provide that a market quotation is readily available for purposes of the Investment Company Act definition of "value" only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date.[33] Thus, the proposed rule would specifically require funds to monitor for circumstances when a market quotation does not meet this proposed criterion for being "readily available."

The proposed rule would further specify that a quotation is not "readily available" for purposes of the Investment Company Act definition of "value" if it is not "reliable,"[34] and would require funds to establish criteria for determining when market quotations are no longer reliable. For example (consistent with the 2001 Letter), the SEC noted that, where a fund invests in non-U.S. securities, the board or adviser should "identify and monitor for the kinds of significant events that" would materially impact a security's value if they occurred after the local market closes but before the fund calculates its NAV.[35] The SEC explained more generally that "a quote would be considered unreliable under proposed

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30 *Id.*

31 Release at 20 n.49. We have observed that advance consideration of valuation methodology is typically addressed when fund advisers consider the use of new instruments and investment techniques.

32 Release at 21 n.50 and accompanying text.

33 Proposed Rule 2a-5(c). This element of the proposed rule is discussed in more detail in the text.

34 *Id.* Thus, among other circumstances, funds would be required to monitor for circumstances when quotations are not "reliable."

35 Release at 21-22.

rule 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."[36]

In concluding this discussion of the establishment and application of fair valuation methodologies, the SEC noted that "there may be a range of appropriate values that could reasonably be considered to be fair value" for any particular investment, and that such a determination will depend upon the facts and circumstances.[37] Under the proposed rule, the fair valuation "methodologies used may reflect this range of potential fair values."[38]

The Release requests comment in response to several questions concerning the establishment and application of fair valuation methodologies, including: whether the various proposed elements are appropriate; whether other elements should be added or certain proposed elements should be removed or modified; whether the SEC should provide additional guidance and (if so) on which elements; and whether there are investments for which it is not feasible to establish a methodology in advance and how the rule should address those situations.

### *Condition 3: Testing of Fair Valuation Methodologies*

The next proposed requirement for determining fair value in good faith is testing the appropriateness and accuracy of the fair value methodologies that have been selected, including identifying the testing methods to be used and the minimum frequency with which such testing methods are used. This proposed requirement is intended to support the proposed requirement discussed above to periodically review the appropriateness and accuracy of selected fair valuation methodologies and make necessary adjustments.

Under the proposed testing requirement, the specific tests and testing frequency are dependent upon the fund's circumstances and are to be determined by the board or adviser, as applicable. The SEC discussed two types of testing, "calibration" and "back-testing," and noted that "calibration" may assist funds in assessing whether a valuation technique reflects current market conditions and whether valuation technique adjustments are appropriate.[39] The Release also states the SEC's belief that calibration and back-testing can be helpful in several ways, including identifying trends and identifying issues with fund service provider's valuation methodologies.[40]

The Release requests comment on several questions related to whether the SEC should require particular types of testing or set a minimum testing frequency and whether the rule should require specific actions based on testing results.

### *Condition 4: Evaluation of Pricing Services*

The fourth requirement for determining fair value in good faith under the proposed rule is overseeing pricing service providers, if used, including establishing: (i) the process for the approval, monitoring and evaluation of each pricing service provider; and (ii) criteria for initiating price challenges. The SEC noted that this requirement is intended to "help

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[36] Release at 58.

[37] Release at 22.

[38] *Id.*

[39] Release at 23 n.57. The Release defines "calibration" for these purposes as "the process for monitoring and evaluating whether there are material differences between the actual price the fund paid to acquire portfolio holdings that received a fair value under the [Investment Company] Act and the prices calculated for those holdings by the fund's fair value methodology at the time of acquisition."

[40] Release at 24.

ensure that pricing information received from pricing services serves as a reliable input for determining fair value in good faith."[41]

These requirements would cover all types of pricing services utilized by funds, including pricing services that supply prices for fixed income securities, which are frequently valued using evaluated prices; pricing services that supply fair value adjustment factors for securities that trade on non-U.S. exchanges; and pricing services that review and evaluate an adviser's valuation of investments held by BDCs. Accordingly, as a practical matter, many funds would be subject to the proposed rule's requirements regarding evaluation of pricing services.

In establishing the process for the approval, monitoring and evaluation of pricing service providers, the SEC noted that the board or adviser, as applicable, should consider factors such as:

- The pricing service's qualifications, experience and history;
- The valuation methods, inputs and assumptions the pricing service uses (including whether the pricing service relies on inputs or assumptions from the adviser), and how changing market conditions affect them;
- The pricing service's process for considering price challenges, including how information from a price challenge is incorporated into pricing information;
- The pricing service's potential conflicts of interest and steps taken to mitigate them; and
- The pricing service's testing process.[42]

The Release asks whether: commenters agree with the proposed requirement for pricing service oversight; other service providers also should be covered by the proposed rule; the proposed rule should clarify who qualifies as a pricing service; and the proposed rule should specifically require periodic review of the selection of pricing services and evaluation of other such services.

### *Condition 5: Adoption and Implementation of Written Policies and Procedures*

Determining fair value in good faith under the proposed rule would require adoption and implementation of written policies and procedures addressing the determination of the fair value of fund investments that are reasonably designed to achieve compliance with the previously-discussed requirements. The SEC noted that, under the proposed rule, if the board determines fair value, the board-approved fair value policies and procedures would be adopted and implemented by the fund; alternatively, if the board assigns fair value determinations to the adviser, the fair value policies and procedures would be adopted and implemented by the adviser subject to board oversight under Rule 38a-1 under the Investment Company Act.[43]

The Release also describes the interaction between proposed Rule 2a-5 and Rule 38a-1, including current requirements with respect to valuation procedures under Rule 38a-1. In particular, the Release indicates that Rule 38a-1 would apply to a fund's obligations under proposed Rule 2a-5. Rule 38a-1 would require a fund's board to oversee

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41 Release at 25; *see also* Money Market Fund Reform; Amendments to Form PF, SEC Rel. No. IC-31166 (July 23, 2014) (2014 Money Market Fund Release) at 285-288.

42 Release at 25-26.

43 Release at 27.

compliance with proposed Rule 2a-5, and the Release notes that Rule 38a-1 requires a fund's CCO to provide an annual report to the board that must address materials changes to compliance policies and procedures, which would include valuation procedures. If adopted, proposed Rule 2a-5's requirements would supersede previous SEC guidance concerning policies and procedures regarding pricing of portfolio securities and fund shares.[44] To the extent adviser policies and procedures under proposed Rule 2a-5 would be duplicative of a fund's Rule 38a-1 valuation policies, the fund could adopt the adviser's Rule 2a-5 policies and procedures in satisfaction of the fund's Rule 38a-1 obligations.[45] Notably, the SEC observed that proposed Rule 2a-5 "would prescribe more specific elements that fair value policies and procedures adopted under the rule must address as compared to the current framework under rule 38a-1."[46]

The Release requests comment as to whether the proposed fair valuation policies and procedures should include elements other than those proposed, and whether the SEC's guidance on the interaction of Rule 38a-1 and proposed Rule 2a-5 is sufficiently clear or if additional guidance is warranted.

### *Condition 6: Recordkeeping*

The final proposed requirement for determining fair value in good faith is the maintenance of certain specific records:

- 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; and

- A copy of the fair valuation policies and procedures discussed above that are in effect, or were in effect at any time within the past five years, in an easily accessible place.

Notably, the SEC stated that the proposed requirement to maintain appropriate documentation to support fair value determinations would include documentation sufficient for third-party verification of fair value determinations.[47] It is unclear whether this means that a third party would have to be able to recreate the valuation from the documents maintained. It is also unclear how such a recordkeeping requirement would apply in the context of fair valuations that rely on inputs from pricing services (*e.g.*, whether it would it be sufficient for the fund to maintain records relating to due diligence of the pricing service's methodologies, rather than records relating to the details of each individual security fair valuation). Depending on the scope of this requirement, it may be impracticable and inconsistent with current industry practices.

The Release requests comment on several related questions, including whether: any additional types of records should be required; the adviser (rather than the fund) should be required to maintain records where the board assigns fair

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44 Release at 28 n.69; *see also* Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IC-26299 (Dec. 17, 2003) at nn.39-47 and accompanying text.

45 Release at 28.

46 Release at 88. The SEC continued, "For example, in addition to the fair value policies and procedures that are required pursuant to rule 38a-1, the proposed rule would require the written policies and procedures to be reasonably designed to address, in the context of methodologies, the selection and application of a methodology in a consistent manner, the specification of which methodologies apply to new types of fund investments in which a fund intends to invest, and testing of the appropriateness and accuracy of the selected methodology, including identifying the testing methods and minimum frequency of testing." *Id.*

47 Release at 29.

value determinations to the adviser; proposed retention periods are appropriate; and key terms are sufficiently understandable.

## "Readily Available Market Quotations"

As discussed above, proposed Rule 2a-5 would provide that a market quotation is readily available for purposes of the Investment Company Act definition of "value" 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.[48] The language essentially mirrors the definition of "Level 1" inputs under ASC Topic 820, which the SEC noted are defined as "[q]uoted prices (unadjusted) in active markets for identical assets ... that the reporting entity can access at the measurement date"[49] The SEC explained that "a quote would be considered unreliable under proposed rule 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."[50] The SEC also noted that evaluated prices, by themselves, are not readily available market quotations, and "indications of interest" and "accommodation quotes" similarly would not be readily available market quotations for purposes of proposed Rule 2a-5.[51] As a practical matter, this means that most fixed income securities – which are often priced using evaluated prices from pricing services – would be considered securities for which market quotations are not readily available and thus subject to fair valuation requirements.

The proposed rule's definition of "readily available market quotations" would, by its terms, apply "[f]or purposes of Section 2(a)(41)" of the Investment Company Act, and the Release does not explicitly address implications for other Investment Company Act provisions that also include this concept. Notably, it is unclear what the implications are for Rule 17a-7, which exempts certain cross trades from the Investment Company Act's affiliated transaction prohibitions but is only available for securities "for which market quotations are readily available."[52] Assuming that the definition would extend to Rule 17a-7, it could preclude reliance on that rule in a variety of circumstances permitted today, most significantly those involving fixed income trades.[53]

The Release requests comment on several matters relating to this proposed definition, including: whether the SEC should depart from ASC Topic 820 for these purposes; how investments in pooled vehicles valued at NAV and not at

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48 Proposed Rule 2a-5(c).

49 Release at 58 n.129. The SEC also noted that, "[d]espite the respective references to 'securities similar in all respects' in the Commission's prior guidance [in ASR 113] and 'identical assets' in ASC Topic 820, we view these respective definitions as being substantively the same." In ASR 113, the SEC had interpreted "readily available market quotations" as meaning "reports of current public quotations for securities similar in all respects to the securities in question." *Id.*

50 Release at 58.

51 Release at 59; *see also* 2014 Money Market Fund Release at 286; Liquidity Rule Adopting Release at 248 n.801 and accompanying text.

52 Specifically, Rule 17a-7 permits cross trades between certain parties provided that: (i) the transaction is a purchase or sale involving no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available; and (ii) the transaction is effected at the current market price of the security. "Current market price" for this purpose means, for securities that are not exchange traded or quoted in the NASDAQ system, "the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry."

53 Funds typically obtain actual bids and offers from broker-dealers in connection with transactions under Rule 17a-7 involving fixed income securities. However, the SEC staff has provided no-action relief contemplating the use of prices provided by a pricing service to effect Rule 17a-7 transactions involving municipal securities. *See, e.g.* Federal Municipal Funds, SEC No-Action Letter (pub. avail. Nov. 20, 2006). In that case, it is acknowledged that market quotations are not readily available for the municipal securities.

market price should be addressed; whether the proposal would cause other compliance issues; whether interpretive guidance would be preferred to rulemaking; and whether practitioners understand what "access to identical investments at the measurement date" means in this context or whether another standard should be used.

## Board (and Adviser) Responsibilities Concerning Fair Valuation

Proposed Rule 2a-5 would expressly place fair valuation responsibilities on a fund's board as required under the language of Section 2(a)(41) of the Investment Company Act, but would permit the board to assign those responsibilities, subject to ongoing oversight, to an investment adviser of the fund (which could include one or more sub-advisers) but not other service providers such as administrators. In the Release, the SEC articulated high-level expectations regarding the nature, scope and tone of board oversight:

- "Boards should approach their oversight of fair value ... with a skeptical and objective view";
- "[E]ffective oversight cannot be a passive activity"; and
- "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."[54]

The SEC also would place the identification, monitoring and management of the adviser's and other service providers' conflicts of interest at the center of the board's oversight role.

An investment adviser assigned fair valuation responsibilities by a fund's board would carry out those responsibilities in accordance with the fair valuation determination requirements set forth above in the "Fair Value Determination" section and subject to the following additional conditions: [55]

- *Periodic Reporting and Written Assessment:* At least quarterly, the adviser would be required to provide to the board in writing an assessment of the adequacy and effectiveness of the investment adviser's process for determining fair value;
- *Prompt Reporting:* The adviser would be required to promptly (and in any case no later than three business days after the adviser becomes aware of the matter)[56] report to the board in writing on matters associated with

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54 Release at 35.

55 The SEC suggested that, where a fund assigns fair valuation responsibilities to an adviser, the adviser might bear the related costs. Release at 98. ("For funds whose boards would assign the fair value determinations to the funds' investment advisers, [the one-time costs associated with implementation of the rule] would be borne by the investment adviser, and could be ultimately passed through to the fund shareholders in the form of higher management fees.").

56 This formulation parallels the time period provided to funds under SEC staff guidance applicable to determining whether a fund has breached its highly liquid investment minimum or the fifteen percent limit on "illiquid" investments under the fund's Rule 22e-4 liquidity risk management program. *See* Investment Company Liquidity Risk Management Programs Frequently Asked Questions, at questions 32 and 33 ("[A] provisional classification may indicate a liquidity issue, but the fund has not yet verified and made a final determination that such an issue actually exists. In these circumstances, a fund may need a reasonable amount of time to determine and verify for itself the impact and validity of the reclassification on the fund's compliance with its limits. In general, the staff believes that this verification and final determination process should be completed within three business days or less, including the day that the triggering event was observed.").

the adviser's process that materially affect, or could have materially affected, the fair value of portfolio investments;

- *Segregate Valuation and Portfolio Management Functions:* The adviser also would be required to specify the titles of persons responsible for determining fair value (including specifying particular functions for which such persons are responsible) and to reasonably segregate the fair value determination process from portfolio management; and

- *Recordkeeping Requirement:* The fund would be required to maintain certain additional records.

While the Release suggests that the proposed requirements are consistent with existing practices currently utilized by fund boards and advisers,[57] the required reports and records in fact go well beyond existing practices of many fund complexes today.

Each condition to a fund board's ability to assign responsibility for fair valuation determinations to one or more investment advisers is discussed in further detail below.

### *Board Oversight over Fair Valuation Determination Assignments*

As noted above, Section 2(a)(41)(B) of the Investment Company Act provides that when market quotations for an instrument are not readily available, the "value" of that instrument means the "fair value as determined in good faith by the board of directors." As a result, the SEC has previously taken the position that a fund board may not delegate the *determination* of fair value but may delegate the task of *calculating* fair values, provided that the board satisfies itself that the resulting fair valuations are fair. Proposed Rule 2a-5 would not change a fund board's statutory obligation with respect to fair value. However, the proposed rule would provide fund boards with alternatives for satisfying their statutory obligation with respect to fair value determinations.

#### Board-Derived Fair Valuation Determinations

A fund's board would be permitted to carry out directly its statutory obligation under Section 2(a)(41) by determining the fair value of fund portfolio holdings. Under this approach, the:

- Board would be required to satisfy the fair value determination requirements set forth in the "Fair Value Determination" section above, and

- Relevant funds would be subject to the policies and procedures and recordkeeping requirements set forth in the "Recordkeeping" sub-section of the "Fair Value Determination" section above.

Importantly, under the proposed rule, a fund's board would be defined as "either the fund's entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund."[58]

The Release does not expressly state whether a fund's board could continue to rely on the existing processes used by many fund boards whereby a fund's adviser calculates fair value at the direction of the board. However, the SEC did

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[57] Release at 72-79.

[58] Proposed Rule 2a-5(e)(3).

request comment regarding whether, for fund boards that elect to conduct fair value determinations, the Commission should provide guidance as to the "level of assistance" the fund board can receive from service providers.

Adviser-Derived Fair Valuation Determinations

As an alternative, the proposed rule would allow a fund board to satisfy its statutory obligation with respect to fair value determinations by assigning responsibility to determine the fair value of one, a subset, or all portfolio holdings to an investment adviser of the fund – which could include one or more sub-advisers[59] – and overseeing the fair valuation process. The Release acknowledges that what would constitute effective oversight could vary by fund complex based on a variety of factors. For example, the Release explains that the appropriate level of scrutiny offered by a fund board could vary based on the relevant fund's "valuation risk, including the extent to which fair value of the fund's investments depend on subjective inputs."[60] Notably, the SEC explained that "[a]s the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, [the SEC] would expect that the board's level of scrutiny would increase correspondingly."[61]

If the fund board assigns responsibility for fair value determinations to one or more investment advisers, then:

- The assigned investment adviser(s) would be required to determine fair valuations consistent with the requirements set forth under the "Fair Value Determination" section above; and

- The board's assignment of fair value responsibilities would be subject to the conditions outlined above related to: (i) periodic reporting and written assessment; (ii) prompt reporting; (iii) segregation of valuation and portfolio management functions; and (iv) recordkeeping requirements.

The Release requests comment on several matters related to this aspect of the proposal, including (among others) whether: the proposed rule would change the services currently provided by advisers with respect to valuation and any associated impact on the board's consideration of a fund's advisory contracts; fund boards should be permitted to assign fair value determination responsibilities to an entity other than an investment adviser of the fund; the assignment for fair value determination responsibility should be limited to the fund's primary adviser; and certain actions should be required to be taken by the full board rather than a committee thereof.

Roles of the Board and the Adviser

The SEC explained that this dual-alternative approach is intended to "provide boards and advisers with a consistent, modern approach to the allocation of fair value functions, while preserving a crucial role for boards to fulfill their obligations under [S]ection 2(a)(41)" of the Investment Company Act.[62] The SEC acknowledged that fair value

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[59] The Release indicates that an assignment to an investment adviser (including a sub-adviser) must cover all elements of the fair valuation determination for a given investment or investments, which could in practice limit the ability to assign responsibilities to a sub-adviser. In addition, the Release acknowledges potential challenges posed when assigning fair value responsibilities to multiple sub-advisers in a multi-manager fund complex. For example, the Release states that "[w]here the board assigns fair value determinations to multiple advisers, the fund's policies and procedures adopted under rule 38a-1 should address the *added complexities* of overseeing multiple assigned advisers in order to be reasonably designed to avoid violating the federal securities laws." Release at 33-34. (emphasis added).

[60] Release at 35.

[61] *Id.*

[62] Release at 32. The Release also states that the "allocation of functions is consistent with" the current framework established under the ASRs 113 and 118.

determinations "often require significant resources and specialized expertise," and that "it may be impracticable for directors themselves to perform every one of the necessary tasks without assistance."[63]

Notwithstanding the option to assign fair value determinations, the SEC expressly stated that the assignment of fair value determinations does not relieve the fund's board of its statutory and fiduciary responsibilities to the fund. In this regard, the SEC explained that a fund board should take care to: (i) monitor for potential conflicts of interest;[64] (ii) probe the appropriateness of the adviser's fair value processes;[65] and (iii) take care in considering the "type, content, and frequency of reports that they receive."[66] Importantly, the SEC noted that a fund board may not be deemed to satisfy its oversight duty if it becomes aware of a material matter but does not inquire about such matter and take reasonable steps to ensure it is addressed.

It is unclear whether the SEC's choice of the term "assignment" to refer to the board's decision to vest responsibility for determining fair valuations in one or more investment advisers, rather than a "delegation," is intended to shape a board's responsibilities. It is not clear from the Release whether, or to what extent, the SEC considered the legal distinction between these terms. The concept of assignment derives from contract and property law and applies to rights and interests, not responsibilities. However, the use of the term "assignment" could be read to mean that a board that assigns responsibility to an investment adviser would be responsible only for taking the steps required under the rule and general oversight in accordance with its fiduciary duties as set forth above (as distinct from a "delegation" under which the board would still retain responsibility for all aspects of valuation). In either case, the Release would clearly allocate to the board a significant role with respect to valuation, whether or not it assigns responsibility to an investment adviser. Unfortunately, the SEC's formulation does not make clear whether a board that has assigned fair value determinations to an adviser bears residual liability for the adviser's mistakes.

Relatedly, it is important to note that the proposed rule does not provide a safe harbor for compliance with a fund board's statutory obligation with respect to fair value determinations. Instead, the proposed rule sets forth a prescriptive set of conditions for satisfying this obligation. This structure leaves open the possibility that a failure to satisfy one or more component obligations under the proposed rule – either knowingly or inadvertently – could result in the fund board failing to satisfy its statutory obligation under Section 2(a)(41)(B). Given the ambiguities in the Release, it is not clear whether the SEC intends to use this residual liability as a basis for enforcement actions against fund directors.

The following provides an overview of each condition to a fund board's assignment of responsibility for fair valuation determinations to one or more investment advisers, as outlined above, and associated SEC guidance included in the Release.

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[63] *See id.*

[64] For example, the SEC explained that (i) an adviser to whom fair value determination responsibilities have been assigned has "an incentive to improperly value fund assets in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions" and (ii) other service providers may have the incentive, or otherwise be subject to pressures, to "provide pricing estimates that are favorable to the adviser." Release at 36.

[65] This may include, among other things, periodically reviewing (i) the "financial resources, technology, staff, and expertise of the assigned adviser," (ii) the "reasonableness of the adviser's reliance on other fund service providers," and (iii) the adviser's compliance capabilities. *Id.*

[66] Similar to the adopting release for Rule 38a-1 under the Investment Company Act, the Release expressly states that a fund 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" but that the fund must "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."

### *Condition to Board Assignment 1: Periodic Reporting and Written Assessment*

Under the proposed rule, any investment adviser to whom fair value determination responsibilities are assigned would be required to provide to the board a written assessment of the adequacy and effectiveness of the investment adviser's process for determining fair value at least quarterly.

The proposed periodic board reporting condition and the prompt board reporting condition discussed in the following section are each intended to provide a fund board with insights into the salient features of an adviser's fair value process. The Release states that any board reporting would be required to "include such information as may be reasonably necessary for the board to evaluate the matters covered in the report."[67] Although the SEC did not elaborate on what level of information would satisfy the "reasonably necessary" standard, it did state that the reports should provide a board with "enough information to determine whether to ask additional questions or request additional information, if appropriate."[68]

Periodic reports from an investment adviser to a fund board would be required to provide, at a minimum, a summary or description of the following six core topics:[69]

1. *Valuation Risks*: Each periodic report would be required to include a description of the adviser's assessment and management of material valuation risks, including material conflicts of interest of the adviser and any other service provider. In this regard, the SEC explained that "managing identified valuation risks is an important element for determining fair value in good faith" because ineffectively managed valuation risks may lead to incorrectly valued investments.

2. *Material Changes and Deviations (Methodologies):* Each periodic report would be required to discuss any material changes to or material deviations from established fair valuation methodologies. This discussion could include, among other matters, changes to key inputs or assumptions and the reasons for such changes. This requirement is intended to ensure that fund boards are notified of methodology changes and are provided an opportunity to question whether methodologies should or must be updated.

3. *Testing Results:* Each periodic report would be required to describe the results of any testing of fair valuation methodologies' accuracy and appropriateness. The results of such testing may indicate to the adviser or the board that adjustments are necessary or appropriate.

4. *Resource Adequacy:* Each periodic report would be required to describe the adequacy of resources allocated to the fair value process, including material changes to the roles or functions of those responsible for that process. For example, the Release indicates that an adviser should disclose when a new pricing service is retained or when advisory personnel responsible for fair valuation are replaced with less experienced

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[67] Release at 42.

[68] *Id.* The Release also does not prescribe a particular format for periodic or prompt reports. Instead, it states that the content of such reports "could take the form of narrative summaries, graphical representations, statistical analyses, dashboards, or exceptions-based reporting, among other methods."

[69] Notably, the Release specifically states that an adviser would not be required to provide a list of each individual portfolio holding that received a fair value since the prior report. Instead, the Release states that a fund board's oversight may be better focused on "targeted forms of reporting designed to identify trends, exceptions, or outliers, and generally provide a sufficient overview of the current state of the fair value process." Release at 43.

personnel. The perceived adequacy of resources may inform a board's determination of the appropriate level of scrutiny of the adviser's fair value process.

5. *Pricing Services:* Each periodic report would be required to describe any material changes to the adviser's process for selecting and overseeing pricing services and related material events (*e.g.*, changes in service providers used or price overrides).[70] For example, the Release suggests that an adviser should disclose circumstances where it seeks to question or override the price provided by a pricing service. This reporting is intended to assist a fund board in assessing whether the pricing services provide reliable fair value inputs.

6. *Other:* Each periodic report would be required to address any other materials requested by the board.

The Release makes clear that the foregoing requirements are intended to supplement, rather than serve as a replacement for, effective board oversight. The Release also includes a list of additional materials that a fund board may consider requesting, "if relevant."[71] While these are not explicitly required, without a clearer disclaimer from the SEC, there is a risk that fund boards and advisers may nonetheless consider the items on this list to be required reports to avoid second-guessing by SEC examinations and enforcement staff.

The Release requests comment on several areas related to the periodic reporting requirement, including (among others): what additional adviser resources would be required to satisfy the periodic reporting requirement; whether any additional information should be required to be included in the periodic reports or whether certain of the proposed categories are inappropriate; whether all or a portion of the information proposed to be provided at least quarterly could be provided on a less frequent basis; whether definitions for the terms "assess" and "material" should be included in any final rulemaking; and whether it is appropriate to require reporting of all price overrides.

### *Condition to Board Assignment 2: Prompt Reporting*

To further support board oversight in the event that fair value determination responsibilities are assigned to one or more investment advisers, the proposed rule would require the adviser promptly (and in any case no later than three business days after the adviser becomes aware of the matter) to report to the board in writing on matters associated with the adviser's process that materially affect, or could have materially affected, the fair value of portfolio investments. This would include, among other matters, any significant deficiency or material weakness in the design or implementation of the adviser's fair value determination process or material changes to such process.[72]

Importantly, the Release states that the phrase "could have materially affected" would capture particular types of circumstances. Specifically, this phrase would refer to "circumstances where ... a matter was detected which affected one security and which may not be material on its own, but, had the matter not been identified, could have materially

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[70] The SEC noted that this would require all price overrides be reported. The Release specifically requests comment as to whether reports should only be required for certain price overrides.

[71] For example, the Release indicates that a board also may request: (i) summaries of adviser price challenges; (ii) calibration and back-testing data regarding directional closeness and accuracy of fair values and next actual market prices; (iii) information regarding stale priced securities; (iv) information regarding internal tolerance threshold breaches; (v) narrative summaries of pricing errors; (vi) reports on pricing vendor due diligence reviews; (vii) results of independent auditor assessments of the valuation process; (viii) information regarding trends in portfolio holdings subject to fair valuation; and (ix) reports on the securities for which fair valuations were determined based on broker-provided information.

[72] The Release provides, as an example of a scenario requiring prompt reporting, a "significant increase in price challenges or overrides."

affected the larger assigned portfolio of investments or some subset of that portfolio."[73] By contrast, the Release explains that this phrase *does not* refer to circumstances where, in hindsight, a matter deemed not to have a material effect at the time of occurrence does, in fact, result in a material effect. Nonetheless, as drafted, the requirement could apply to a broad set of circumstances and could require almost constant reporting during times of market volatility, when valuation processes are continuously being evaluated in light of market events.

The Release explains that the term "prompt" may require immediate board reporting in some circumstances but also provides sufficient flexibility for an adviser to evaluate a matter identified before providing board reporting. Specifically, the SEC recognized that determining and verifying whether an event has or could materially affect fair value can, in some cases, take time. The SEC provided that "if an adviser needs some reasonable amount of time after becoming aware of the matter to verify and determine its materiality, that verification period would not be counted as part of the 'prompt' trigger period."[74] This process should be completed within three business days, including the day the adviser became aware of the event.

The Release requests comment on several areas related to the prompt reporting requirement, including (among others) whether: the prompt reporting requirement is appropriate; a bright line test should be provided for determining whether a prompt report is required; additional context is required to clearly delineate what is meant by the terms "materially affecting" and "could have materially affected"; oral (in lieu of written) reports could be appropriate in some or all circumstances; advisers can make the required determination for whether a prompt report is required under the timeline proposed; and a different timeline for prompt reporting to a fund board would be appropriate.

### *Condition to Board Assignment 3: Segregation of Valuation and Portfolio Management Processes*

The proposed rule also would require that any adviser to whom fair value determinations are assigned would be required to specify the titles of persons responsible for determining fair value (including specifying particular functions for which such persons are responsible) and to reasonably segregate the fair value determination process from portfolio management. The SEC stated that applicable valuation policies and procedures should also (i) "identify the specific personnel with duties associated with price challenges, including those with authority to override a price, and the roles and responsibilities of such persons" and (ii) "establish a process for the review of price overrides."[75]

Addressing the requirement to specify the titles of persons responsible for fair value determinations, the Release acknowledges that such determinations could be made by, or with input from, a valuation committee or similar body. Under these circumstances, an adviser would comply with this condition by describing the committee's composition and role, including through reference to the committee's governance documents.

In explaining the requirement to segregate valuation and portfolio management functions, the Release indicates that portfolio managers should not be ultimately responsible for fair value determinations because they are "a significant source of potential adviser conflicts of interest in the fair value determination process." [76] However, the SEC acknowledged that despite the potential for conflicts of interest, portfolio managers can provide relevant inputs in the fair value determination process and "may be the most knowledgeable person at an investment adviser regarding a

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[73] Release at 49.

[74] *Id.*

[75] Release at 53.

[76] *Id.*

fund's portfolio holdings."[77] Accordingly, the proposed rule would require "reasonable segregation of functions"[78] and would allow funds to structure the fair value process in light of the fund's facts and circumstances, including the "size and resources" of the adviser to whom fair value determination responsibility is assigned. The Release indicates that reasonable segregation could be achieved through a variety of means including, among others, "independent reporting chains, oversight arrangements, or separate monitoring systems and personnel."[79] However, a "firewall" on communications between portfolio management and valuation personnel expressly would not be required.

The Release requests comment on several areas related to the requirement to segregate valuation and portfolio management functions, including (among others) whether: the proposed segregation requirement would pose challenges for advisers; other alternatives would more appropriately address the policy concerns underlying the segregation requirement; and additional clarification would be appropriate.

### *Condition to Board Assignment 4: Recordkeeping Requirements*

Finally, a fund for which fair value determination responsibility has been assigned to one or more investment advisers would be subject to certain additional recordkeeping requirements. Specifically, the fund would be required to, in addition to any records required as part of the good faith fair valuation process generally, keep:

- Copies of the periodic and prompt reports provided to the fund board; and
- A list of investments or investment types whose fair value determinations have been assigned pursuant to the proposed rule.

In each case, the required records would be required to be maintained for at least five years after the end of the fiscal year in which the documents were provided to the fund's board or the investments or investment types were assigned, the first two years in an easily accessible place. The Release indicates that this recordkeeping requirement is intended to "facilitate the board's oversight of the adviser's fair value determinations," as well as to facilitate compliance with the proposed rule and related SEC oversight.

The Release requests comment on several areas related to the recordkeeping requirements, including (among others) whether all or a portion of the proposed required records should be maintained by the adviser rather than the fund and whether the proposed holding periods are appropriate.

## Rescission of Prior Commission Releases, Existing SEC Staff No-Action Letters and Other Guidance

With a view towards modernizing the approach for fund valuation, as noted above, the SEC is proposing to rescind ASR 113 and ASR 118 following the adoption and effectiveness of a final version of Rule 2a-5. The Release indicates that developments in FASB accounting standards "have modernized the approach to accounting topics" addressed in ASR 113 and ASR 118 and that such developments, coupled with the evolution of market and fund investment practices, have rendered the ASRs to "no longer be necessary."[80] In addition, the Release indicates that SEC staff

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[77] Release at 54.

[78] The Release expressly indicates that the SEC declined to impose more prescriptive requirements such as mandating protocols for communications between portfolio managers and valuation personnel.

[79] Release at 54.

[80] Release at 60-61.

letters and other guidance that would be superseded by or otherwise inconsistent with the final rule would be rescinded in connection with its adoption. The Release sets forth a list of letters and other guidance that the SEC expects to be rescinded, including the two letters to the Investment Company Institute noted above. To the extent that industry participants believe that certain guidance should or should not be withdrawn or that the withdrawal of certain guidance will have unintended practical consequences on funds, it will be important to note such guidance as part of the proposed rule comment process.

The Release requests comment on several areas related to the proposal to rescind existing valuation guidance, including (among others) whether: industry participants agree that all of the guidance in ASR 113 and ASR 118 has been rendered unnecessary; the SEC should retain its statement in ASR 118 regarding verification by an independent accountant of all quotations for securities with readily available market quotations at the balance sheet date; and there are other specific SEC staff letters or guidance (beyond those specified) that should be rescinded.

## Key Dates and Timing

The SEC proposed a one-year transition period for proposed Rule 2a-5. If adopted, proposed Rule 2a-5 would become effective one year following Federal Register publication of the final rule.

Comments on the SEC's proposal are due by July 21, 2020.

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