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# Next on the SEC's regulatory agenda: a chief valuation officer?

It's not hard to picture a CVO seat at the already crowded officer table

*By Jay Baris*

First, the Securities and Exchange Commission required funds to designate a chief compliance officer. Then, the SEC proposed that funds designate a liquidity risk manager, and after that, a derivatives risk manager. Can a chief valuation officer (CVO) be far behind?

Looking into our crystal ball, this may be possible, especially since the regulatory model is already in place.

## Board responsibility to fair value securities

When market quotations are not readily available, the Investment Company Act of 1940 requires fund directors, in good faith, to determine the fair value of portfolio securities. Although fund directors cannot delegate this responsibility, they can delegate the calculation of fair valuations in accordance with methodologies that they approve.

"It is incumbent upon the board of directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered," the SEC wrote in 1969 guidance. Fund directors "must … continuously review the appropriateness of the method used in valuing each issue of security in the [fund's] portfolio."

This is a tall order. Back then, however, most portfolio securities were plain vanilla and no one ever heard of derivatives, exchange-traded funds or liquid alternative funds.

But as investment companies evolved and grew more complex, so did the role and responsibilities of fund directors.

## The chief compliance officer

In December 2003, following the market timing and late-day trading scandals, the SEC adopted Rule 38a-1, which requires registered funds to adopt and implement compliance programs reasonably designed to prevent violations of the federal securities laws. As part of that rule, the SEC for the first time required fund boards, including a majority of the independent directors, to designate a chief compliance officer responsible for administering the fund's compliance policies and procedures. The fund's board must approve the CCO's compensation. While the CCO can be employed by the fund's investment adviser, the CCO cannot be fired without the approval of the board, including a majority of the independent directors.

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## Concern about systemic risks

Let's fast forward to the present. In the aftermath of the financial crisis of 2008, Congress enacted the Dodd-Frank Act, which, among other things, sought to rein in Wall Street. The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC), giving it broad powers to monitor and prevent systemic risk posed by non-bank financial institutions. FSOC has often stated that asset managers and certain kinds of pooled funds, may present systemic risk to the financial system.

Meanwhile, in part as a result of the Dodd-Frank Act's limits on the powers of banks to trade for their own accounts, there is pressure on the fixed income markets that leads to concerns about liquidity. Liquidity concerns came to a head when a large money market fund "broke the buck" in 2008, and a fixed income fund famously suspended redemptions in 2015. These events, among others, prompted fears that funds holding fixed income securities or illiquid investments would not be able to meet redemptions in the event of a run on the fund.

## Risk officers everywhere

In light of these developments, some funds as a matter of best practice have designated a chief risk manager (CRM) charged with the responsibly of monitoring overall fund risk and reporting on these risks to the fund's board. Sometimes, the CRM is also the fund's CCO.

In September 2015, the SEC proposed rules that would require funds to implement certain liquidity risk management programs. The proposal would require funds to designate the fund's investment adviser or officers responsible for administering the fund's liquidity risk management program. The liquidity risk manager (LRM) may be the existing CRM, but would not be solely a portfolio manager of the fund. The SEC asked for public comment as to whether a fund should be required to specifically task administration of the fund's liquidity risk management program to a dedicated risk officer.

Three months later, the SEC proposed rules that would limit the ability of funds to use derivatives and leverage. These rules would require funds, other than those that engage only in a limited amount of derivatives transactions and do not use certain "complex derivatives transactions," to establish a formalized derivatives risk management program. The rule would require funds to designate a derivatives risk manager (DRM), who would be responsible for administering the derivatives risk program.

The rule would require fund boards to designate the DRM, who cannot be a portfolio manager of the fund. But unlike the requirement for a CCO, the rules would not require that a DRM only be removable by the board, nor would the board need to approve the DRM's compensation. The SEC asked for public comment on whether it should require that only the fund's board be permitted to remove the DRM or establish the DRM's compensation, as in the case of the CCO.

## SEC valuation guidance

Other clues point in the direction that the SEC may require a CVO. For example, in 2014, buried in the SEC's 893-page money market fund reform release, the SEC included guidance concerning valuation of portfolio securities. The guidance was not limited to money market funds, but applied to all investment companies.

> This valuation guidance presents additional challenges for fund directors."
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In the money market fund release, the SEC acknowledged that matrix pricing and similar pricing methods involve estimates and judgments, "and thus may introduce some 'noise' into portfolio security prices." The SEC then discussed the role of third-party pricing services.

Before deciding to use evaluated prices to "assist it in determining the fair values of a fund's portfolio securities," a fund's board "may want to consider the inputs, methods, models and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models and assumptions are affected (if at all) as markets change." The SEC described mechanisms that fund boards can utilize to assess the evaluated prices provided by the third-party pricing services.

## The ever-growing director's role

This valuation guidance presents additional challenges for fund directors who are already burdened with responsibilities to monitor overall portfolio risk and may soon bear increased responsibility for specific oversight of liquidity risk and derivatives risk, among other things. Fund boards now must designate a CCO, and may soon need to consider appointing a liquidity risk manager and a derivatives risk manager. It would not stretch the imagination for the SEC to take a cue from its playbook and require funds to designate a CVO seat at an already crowded officer table.